Global Trade Patterns, Foreign Direct Investment, and Egypt's Export Strategy

Draft Report

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Contents

Executive Summary

The current decade has witnessed the ascent to prominence of the "new global economy," rivaling the remarkable period of closer economic ties in the world economy during the late-Nineteenth Century and early-Twentieth Century. Broadly speaking, globalization refers to increasing integration of economic activities across national boundaries, through not only greater specialization in production and international trade but also increasing integration of financial and capital markets among countries.

In the context of Egypt's "aid-to-trade" strategy, globalization holds considerable promise for Egypt. Indeed, trade, growth, and economic development in increasing numbers of so-called emerging-market countries have been spurred during the last decade by dramatically greater flows of private investment from abroad in response to more open, free market economic policies and institutions adopted by these countries, importantly following the example of successful East and Southeast Asian countries.

Egypt is appropriately included among emerging-market countries owing to the country's commitment to major economic reforms, which to date has been expressed importantly in the adoption of prudent macroeconomic policies under the Economic Reform and Structural Adjustment Program begun in 1991, gradual privatization of state-owned enterprises, reform of company laws, and rekindling of equity markets. Moreover, Egypt has also come to look to foreign direct investment by multinational enterprises and other private foreign investors as a path to helping Egypt modernize its economy, boost and diversify its output and exports, and improve employment opportunities for its large population.

Unfortunately, Egypt has not succeeded in significantly increasing foreign direct investment inflows to the country in comparison to the experience of most emerging-market countries, raising concerns in the country for the process of globalization and for whether Egypt can count on enjoying the alleged fruits of global economic integration, especially improved export performance, greater technology transfer, and enhanced economywide economic efficiency and growth.

In response to such concerns, the present report reviews the economic theory and evidence on globalization, foreign direct investment, and international trade. It also reviews studies of the experiences of Egypt and similar low-to-middle-income developing countries with foreign direct investment and its hypothesized role in propelling trade and employment, economic efficiency, and growth in the new global economy. It also presents the broad outline of a medium-term (two-year), USAID-funded program of focused economic research and analysis on Egypt's potential for expanded participation in the global economy through greater foreign direct investment and international trade.

Although economic theory and empirical evidence are far from entirely unequivocal on the subject, modern theories of foreign direct investment and an

increasing body of empirical evidence indicate that foreign direct investment can be a useful partner for promoting exports, growth, and economic development. If attracted by the right host-country policy environment, that is, a stable, inflation-free macroeconomic environment, along with outward-oriented foreign trade and investment regimes, foreign direct investment can play a substantial and leading role in enhancing a country's international competitiveness. In contrast to policies that reward investments catering to the domestic market (arguably the situation of Egypt today), embracing freer foreign trade and investment opens the possibility for enticing foreign direct investment into expanding the base of manufacturing exports in a manner consistent with the country's underlying comparative advantage in labor-intensive manufactures, in addition to traditional mineral fuels-based goods. Indeed, dismal export performance led by the apparent inability of what is essentially a labor-abundant economy to compete internationally in light manufactures (if not also more advanced industrial products), constitutes one of the key bottlenecks to more dynamic performance of the Egyptian economy today.

Foreign direct investment can be a major catalyst for jump-starting Egyptian exports and, in this way, for securing greater integration of Egypt in the new global economy. In addition to creation of more jobs and generation of foreign exchange, this strategy would also augur well for more sustained and equitable economic growth, wider adoption of technologies and general knowhow to help raise total factor productivity, and greater alleviation of poverty in Egypt.

Egypt offers important potential advantages for multinational enterprises seeking to establish competitive advantages worldwide, through outsourcing of intermediate goods and establishment of "export platforms" for producing and exporting goods at many different stages of the production chain. Beyond the advantages of a stable macroeconomic environment, Egypt's geographical location at the crossroads of the Middle East and North Africa gives strategic proximity to European markets. Most important, Egypt features one of the largest pools of labor in the Middle East and North Africa (MENA) region, including large cadres of skilled workers and managerial talent.

Against these advantages however, as discussed in this report, there are impediments that cannot be ignored. One of the most important is that the process of foreign trade and investment liberalization in Egypt is perceptibly behind similar reforms to external economic policies underway in other countries, both within MENA and outside the region. Arguably, more than the investment regime, it is the trade regime that is in need of more decisive reform in Egypt, as local and foreign investors must contend with high tariffs and numerous procedural restrictions on imports that impart an anti-export bias to the economy and, so, discourage crucial outward-oriented foreign direct investment from locating in Egypt. Other key impediments include the fact that the country is lagging behind in the adoption of information technology and, most importantly, that costs of doing business (so-called transactions costs) are far too high. In Egypt, more so than other emerging-market countries, foreign investors must contend with confusing and non-transparent legal regimes, cumbersome requirements for

establishment and licensing of operations, unnecessary delays and red tape, and a bureaucracy that wields excessive discretionary powers.

In order to identify constraints to more dynamic performance of foreign direct investment and to positive "spillover effects" on the Egyptian economy, the report proposes undertaking a medium-term program of USAID-funded research and analysis on the seven topics listed below, which span such issues as current and prospective global production sharing by Egypt, impacts on the Egyptian economy of inward-oriented versus outward-oriented foreign direct investment, and the impacts of high transactions costs in Egypt on foreign direct investment. Combined with elements of the present report, the proposed program of studies could form the nucleus for a USAID-funded economic conference during 2000, and even a publishable volume on the importance of foreign direct investment for propelling Egypt's exports and the country's full-fledged integration in the new global economy.

Topics for Future Research and Analysis

No. 1. Globalization and Worldwide Production Sharing by Egypt
No. 2. Foreign Direct Investment in Egypt: Impacts and Benefits
No. 3. Transactions Costs and Foreign Direct Investment in Egypt
No. 4. Non-Traditional Forms of Foreign Direct Investment
No. 5. Foreign Direct Investment and Development of Small and Medium-Sized Enterprises in Egypt
No. 6. Determinants of Foreign Direct Investment in MENA: An Exploratory Empirical Analysis
No. 7. Foreign Direct Investment and Regional Integration Arrangements in MENA

1. Introduction

Notwithstanding a resurgence of regionalism, the 1990s have witnessed the ascent to prominence of the "new global economy," rivaling (but not eclipsing) the remarkable period of expansion of economic ties between leading countries in the world economy during the late Nineteenth Century and early Twentieth Century (Bordo and Krajnyak 1997; Rodrik 1997).[1] Broadly speaking, globalization refers to increasing integration of economic activities across national boundaries, through not only greater specialization in production and international trade but also increasing integration of financial and capital markets among countries. In the context of Egypt's interest in promoting economic development through more dynamic and robust export performance – Egypt's "aid-to-trade" strategy, globalization holds considerable promise. Increasing economic integration in the world today prominently includes not only advanced industrial countries, but also increasing numbers of so-called emerging-market countries whose growth and development have been spurred by increased private investment flows from abroad in response to more open, free market-oriented economic policies and institutions in these countries.

Egypt is appropriately included in numbers of emerging-market countries owing to the country's commitment to economic reform, which to date has been expressed importantly in the adoption of prudent macroeconomic policies under the Economic Reform and Structural Adjustment Program begun in 1991, gradual privatization of state-owned enterprises, reform of company laws, and rekindling of equity markets (Sachs 1996, ERF 1996, Subramanian 1997a 1997b, DEPRA 1998a). Moreover, Egypt has also come to look to foreign direct investment by multinational enterprises (MNEs) and other private foreign investors to help fund modernization of Egypt's economy, boost and diversify output and exports, and improve employment opportunities for the country's large population. Thus, in his keynote address to the 1997 World Economic Forum meeting in Davos, Switzerland, President Hosni Mubarak declared,

> Egypt has joined the global economy, irreversibly, without doubt, confident in its reforms, uncompromising in its commitment … Free markets are now the main arbiter for the allocation of resources in Egypt. The private sector plays an essential role, increasingly setting the pace, generating employment, and seeking the rightful place that is Egypt's in the region and the world financial community (WEF 1997).

Unfortunately, to date Egypt has not succeeded in substantially increasing foreign direct investment inflows to the country on a per capita basis in comparison to the experience of most emerging-market countries, including especially Israel and Morocco in the Mena region (Table 1.1, lower panel). Indeed, Egypt is among the few emerging-market countries to have witnessed a decline in net per capita inflows of foreign direct

[1] On the resurgence of regionalism in the world economy, see, for instance, de Melo and Panagariya (1993).

investment in 1996 compared to 1990. Moreover, popular indices of free market policies in advanced and less developed countries suggest that Egypt's attractiveness to foreign investors and international competitiveness show no improvement since 1996. For instance, the Heritage Foundation/Wall Street Journal *Index of Economic Freedom* (Holmes, Johnson, and Kirkpatrick 1998) rates barriers to foreign investment in Egypt in the moderate to high range, and the World Economic Forum *Global Competitiveness Report* (WEF 1998) reports a decline (of about 25 percent) in Egypt's international competitiveness vis-à-vis other emerging-market countries.

Egypt's lack of success in attracting greater foreign direct investment during the 1990s has raised concerns in Egypt, heightened by the 1997/98 financial crisis in Asia, for the process of globalization and whether Egypt can count on enjoying the alleged fruits of global economic integration and attendant growth of the world economy, flowing principally through greater foreign direct investment and related improvements in export performance, technology transfer, and economywide efficiency. In response to such concerns, this report reviews the economic theory and evidence on globalization, foreign investment, and international trade. It also reviews studies of the experiences of Egypt and similar low-to-middle-income developing countries with foreign direct investment and its hypothesized role in propelling trade and employment, economic efficiency, and growth in the new global economy.

The remainder of this report is developed in four sections. First, Section 2 considers at some length the concept of globalization, and examines historical trends in foreign direct investment, trade, and economic growth, globally and by major groups of advanced countries and less developed countries. It also considers indicators of the emerging importance of multinational enterprises and their intra-firm trade, as vehicles for increasing trade and economic integration in the world economy. Next, Section 3 reviews traditional and modern theories of the interrelationships among international trade, foreign direct investment, and the "spillover" effects that these flows can have on economic productivity, trade and employment, and growth, especially in "host" less developed countries. In addition, it reviews general empirical evidence on these interrelationships. Next, Section 4 focuses on the experiences of Egypt and similar low-to-middle-income developing countries with foreign direct investment, trade and employment, and economic growth. Finally, Section 5 presents the broad outline of a medium-term (two-year) USAID-funded program of focused economic research and analysis on prime aspects and hindrances to Egypt's potential for expanded participation in the global economy through greater foreign direct investment and international trade.

2. Globalization, FDI, and Trade: Concepts and Historical Trends

Definition of Globalization

Globalization refers to the increasing internationalization of production, distribution and marketing of goods and services. It entails an on-going, dynamic economic process in which the production and financial structures of countries are becoming inter-linked by an increasing number of cross-border transactions. Such a process shapes an international division of labor in which national wealth creation comes, increasingly, to depend on economic agents in other countries. In a world economy that is rapidly becoming more globalized, savers in developed countries offer financial resources that flow with ease to finance consumption and investment in both other developed and developing countries. High-skilled workers in developing countries are linked "on-line" with professionals in developed countries to provide inputs in the creation of knowledge-intensive products and are thus engaged directly in the creation and worldwide diffusion of new technologies. By way of their being employed by multinational enterprises (MNEs), unskilled and semi-skilled workers in developing countries play an important role in the expansion of foreign trade. In all, MNEs are central actors in the process of globalization, especially during the last two decades or more. Globalization offers these entities enhanced if not unlimited opportunities for innovation, expansion and sustained profits. The MNEs, at the same time, act as catalysts. If anything, the globalization process is driven by the production, distribution and marketing of goods and services that are concentrated in these entities.

Globalization has drawn increasing attention since the collapse of the former centrally planned economies in 1989, and most recently since the financial and economic crises that has afflicted East and Southeast Asian countries. One fact must be underscored: for all the current talk about globalization, it is worth noting that the level of world economic integration among countries still falls short of full integration. For this to happen, worldwide wages would be set at Chinese levels, interest rates would be determined in the New York market, and taxes in the Cayman islands (Rodrick, 1998). It is also interesting to note that current world trade flows, measured as a percentage of world GDP, are actually slightly lower than those prevailing during the period prior to World War I.[2] Yet, the signs are unequivocal: globalization is steadily increasing economic interdependence among both developed and developing countries. Spurred since the 1970s by successfully concluded rounds of multilateral trade negotiations, deregulation of domestic economies, more open foreign investment regimes, financial liberalization, and unimpeded information and technology flows, it is a process bound to gain even more momentum as the further development of high-value added, knowledge-

[2] In industrialized countries, which account for the bulk of world trade, the share of exports to in GDP was 21.2% in 1913 and 17% in 1992. Only by excluding the share of services in GDP, that is, by taking the ratio of trade to the production of goods only, would the current trade ratio show an increase with respect to the levels registered pre-1914 (Streeten 1997).

intensive industries intensifies, and as traditional services such as marketing and distribution become more tradable.[3]

Globalization has transformed the economic conditions of all countries. Its impact, however, is largely uneven. Countries which have benefited most are those that embrace the process decisively, with the objective of inserting their economies onto the world economy in a dynamic and competitive way. In this regard, it is worth underscoring that the bulk of trade and investment flows still takes place within the G-7 and other OECD countries (the core countries), and only a handful of developing countries among which stand out the Asian newly industrializing countries (NICs) and the largest Latin American economies (Tables 2.1 and 2.2). The weight of Middle East and North African countries (Mena) on world trade is for all practical purposes inconsequential, and their share on world FDI inflows is insignificant.[4] For these countries, as well as for those which comprise Sub-Sahara Africa, South Asia (Afghanistan, Bangladesh, Bhutan, India, Nepal and Pakistan), and the least developed economies of Latin America, the danger is to be bypassed, or "marginalized," by the process of economic globalization. The cost of muddling through and/or of remaining "idle," that is, being passive spectators of a rapidly changing world economy is prohibitively high. For one, they remain prone to external shocks of commodity prices. In addition, there is a considerable cost in the form of missing opportunities. Developing countries that do not enact more open trade and foreign investment regimes give up productivity gains and therefore the additional incomes that are crucial to alleviate poverty.

Choosing to participate fully in world markets entails challenging the notion that the international division of labor is a static phenomenon. As noted above, the globalization process shapes the international division of labor. Until the 1960s, production of industrial goods was concentrated in the United States, Western and Central Europe, and Japan, while developing countries relied primarily on commodity exports to participate in world trade. Within this group, a number of both large countries, such as India and Pakistan, Mexico, Brazil, Argentina and Venezuela and Egypt, and those with smaller economies, such as Chile, Peru, Morocco and Philippines, did manage to propel industrial sectors that were purposefully shielded from foreign competition.[5]

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[3] Drucker (1986) provides an insightful analysis of how the world economy has been transformed since the early 1970s. The information revolution is one key factor that has made it possible the emergence of knowledge-based industries as leading sectors, with faster productivity growth than traditional material-based industries. This development opens opportunities for innovation and fast expansion of other types of services, such as data processing, management consulting and telecommunications, which are also becoming increasingly tradable. It must be noted that the share of services in developed country GDP has increased considerably in the last three decades. Interestingly, the activities of MNEs mirror this trend. As such, while in 1970 services constituted 25% of world stock of FDI, by the late 1980s such proportion was 50% and represented 55 to 60% of annual flows (Daniels 1996).

[4] Unless, of course, the oil exporting economies, most notably Saudi Arabia, are included.

[5] This corresponded to the strategy of industrialization via import substitution (ISI) that was conceptually underpinned by the infant industry rationale and by notions that terms of trade historically turns against producers of primary commodities. Open-ended application of policies that underlined high rates of effective protection -- high tariff rates on final goods, overvaluation of the exchange rate, import quotas -- was characteristic. As a result, industry developed in captive markets and was not internationally

Since the late-1960s, however, a new phase of the international division of labor began. It is characterized by the gradual phasing out of capital-intensive industries in the core countries and by major foreign direct investment in developing countries to support the expansion of industrial exports (Coffey 1996). In some developing countries, most notably in those located in East and Southeast Asia, internationally competitive industrialization has grown by leaps and bounds. In this process, MNEs have played a prominent if not critical role, whether by licensing technologies to host country conglomerates, as in the case of South Korea, or by direct investment in industrial facilities (Hong Kong, Indonesia, Malaysia, Philippines, Thailand, and Singapore).[6] If anything, by demonstrating that countries can indeed develop world competitive industries and thus escape over-reliance on commodity exports, these far reaching events have served to further undermine the credibility of dependency theory and notions of North-South unequal exchange that dominated economic research and multilateral negotiations well into the 1970s.[7]

Linkages, Trends and Proximate Factors

Countries are linked with the rest of the world via the asset, factor, and goods markets (Dornbusch and Helmers 1988). Each of these is briefly analyzed.

Asset Markets

The international linkage of asset markets relates to the exponential growth of highly liquid financial instruments observed in the last 25 years. These assets include fixed-income bonds, currencies, foreign stocks, and other financial instruments. Largely because capital controls are being dismantled in both developed and developing countries, and because of the far reaching technological changes that have drastically changed the communication and information industries, large volumes of international transactions can be effected in the span of a minute.

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competitive. It also did very little to break the economic dependence of developing countries' exports on primary commodities.

[6] Industrialization proceeded so massively in these countries that it has prompted some analysts to recognize the emergence of a "newer" international division of labor (Coffey 1996). More than their role as recipients of foreign direct investment to support manufacturing exports, this "newer" phenomenom recognizes distinctive features in these countries: first, domestic firms in host countries are developing stable local supply relationships not only with MNEs that have set up shop in their own countries, but with MNEs worldwide. Second, an increasing share of activities relocated from the core countries involves the provision of services. Third, some domestic firms in NICs have become MNEs themselves and engage in outward FDI in countries that are less advanced. Example of this latter phenomenom are the conglomerates of South Korea and Chile.

[7] It must be emphasized once again that this positive development is confined to a handful of developing countries. To this day, the bulk of them have been largely bypassed by the wave of outward industrialization. For example some 40 countries located mostly in Africa and Latin America still play the role of specialized suppliers of natural resources, that is, the same role played during their Colonial times. And another 50 countries, most of them in Africa, maintain weak linkages with the rest of world, mainly as exporters of small volumes of commodities (Coffey, in Daniels and Lever, 1996).

International assets dwarf the international reserves of most countries of the world. In general terms, international asset transactions respond to nominal interest rate differentials between countries and to the expectation of currency depreciation.[8] On the other hand, it can also be argued that these flows are very volatile in nature, and that the large fluctuations that are observed may be due in part to factors external to the developing countries.[9] The impact from these fluctuations can be pervasive, especially in times of financial and economic crisis. In this regard, while domestic economic and political factors undoubtedly played an important role in setting off the crises of Mexico in 1994 and Asian countries in 1997, it can hardly be denied that the high degree of capital mobility did contribute to plunge these countries into severe economic recession (Sachs 1997). It is indeed telling that these countries had liberalized their capital accounts, whereas China, a country that never did and was (and still is) suspect of macroeconomic mismanagement, was largely spared from the Asian financial meltdown.[10] Short of imposing capital controls that breed inefficiency and are difficult to enforce, the best that developing countries can do to cope with the threat of massive capital outflows is pursue monetary and fiscal policies conducive to achieving price stability and a competitive real exchange rate. In the wake of the Asian financial crisis, it is also increasingly clear that developing countries must adopt and enforce prudential controls and regulations on domestic banks and financial intermediaries (Krugman 1998).

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[8] In a two country model, say the United States and Mexico, the decision to hold securities of the latter country is influenced by changes in short term US interest rates and by expectations on the fluctuations in the dollar/peso exchange rate. The expectation of a sustainable appreciation of the peso and/or a reduction of nominal US interest rates would normally increase holdings of Mexican securities (capital inflow for Mexico). Conversely, the expectation of peso depreciation and/or an increase in nominal US interest rates leads to capital flight from Mexico, unless of course the economic authorities in this country decide to substantially raise their domestic rates. But the economic cost, in terms of foregone output, could be prohibitively high.

[9] Such factors include "herd" behavior and how interest rates are determined in the core countries. "Herd" behavior in financial markets is akin to the "follow the leader" process observed in foreign direct investment. The difference is that risk ceases being country specific. Rather, it is determined by perceptions of conditions in regional or emerging markets at large. Another key difference is that the impact is felt immediately, which can be devastating when lenders rush to the exit, even in countries that are pursuing sound macroeconomic policies. A clear example is that of Argentina following the Mexican crisis of 1994. This country suffered the withdrawal of foreign lenders and a bank run that wiped out one third of deposits. The resulting sky-high interest rates led the economy into a severe recession. With respect to interest rates, US economic policy plays a determining role. For example, in the early 1980s, the combination of monetary contraction and fiscal expansion sent real rates sky-high. A worldwide recession followed suit. The consequence for heavily indebted developing countries was devastating, as their terms of trade deteriorated and debt servicing became substantially more expensive.

[10] This is not to advocate that developing countries would be better off with controls on capital account transactions. Rather there is a proper timing for the liberalization of the capital account, which should sequentially follow the balancing of fiscal finances, the stabilization of the price level, the liberalization of current account transactions, the deregulation of domestic financial markets, and the upgrading of bank prudential norms and supervision capabilities (McKinnon 1991). These policy prescriptions were proposed as a result of the painful lessons learned from the premature financial liberalization experienced by Chile, Argentina and Uruguay in the late 1970s. Nonetheless, in discussing the roots of the Mexican crisis of 1994, McKinnon (1995) warned of the dangers from the unfettered mobility of capital.

Yet, as Table 2.3 shows, the 1990s have been characterized by increasing bond and portfolio equity inflows to developing countries. And this brings another set of problems: massive short-term inflows, by way of financing accumulation of foreign reserves or current account deficits, may constitute an important source of macroeconomic turbulence, for the direct impact they have on money and prices, on interest rates and asset prices and, most importantly, on the real exchange rate (Hausmann and Rojas Suárez, 1996). Building reserves can lead to excessive growth of monetary aggregates that must be sterilized to avoid an excessive domestic inflation. But, as evidenced by the experiences of Colombia and Chile early in the decade, partial or total sterilization is costly: it normally leads to rising domestic interest rates and higher quasi-fiscal deficits. On the other hand, long periods of large capital inflows are normally accompanied by current account deficits. If generated not by lower domestic savings but by increasing investment flows in the tradable sector, current account deficits should not cause much concern, especially if investments do not exhibit long gestation periods. But there is the risk that they may be excessively large and accompanied by substantial real exchange rate appreciation.[11] As painfully demonstrated by the experience of Mexico in late-1994 and early-1995, this paves the way for a quick reversal of the flows.

Furthermore, the impact on the other two channels to world markets -- trade and investment -- can be particularly pervasive in developing countries (Akyüz and Held 1995). For all investors, but especially for those who concentrate operations in the traded goods sector, the exchange rate is the most important relative price affecting profits. When fluctuations in the exchange rate are unpredictable, prospective yields of investment become more uncertain with the unfortunate consequence that investments decisions tend to be put off. Under circumstances in which investors perceive the exchange rate as unstable and/or prone to significant depreciation, even countries that traditionally feature a firm commitment towards promoting outward-oriented foreign direct investment will face a hard sale. Last but not least, trade and investment are impaired by rising domestic interest rates. These rise because exchange rate instability increases borrower's risk, and also because financial openness considerably reduces the transactions costs of shifting into foreign currency-denominated financial assets. Under these circumstances, and given the context of uncertainty, economic and political instability, and unpredictable legal systems that permeate developing countries, domestic currency-denominated financial assets must necessarily carry a much higher rates of

[11] See Daly and Harris (1998) for a discussion of these issues in the context of the Andean countries of the Latin American region. Real exchange rate appreciation accompanied vast capital inflows in the 1970s, i.e., the decade of commercial borrowing that preceded the debt crisis of 1982. On the other hand, large outflows correlate more with sharp adjustments in the current account and real exchange rate depreciation, as evidenced in the entire region throughout the 1980s. This was also the experience of Mexico following the crisis of 1994. It is also interesting to note that, unlike Latin American countries, capital inflows to Southeast Asian countries were not accompanied by real exchange rate appreciation, at least until 1994. In point of fact, these countries, during the period 1990-94 experienced real exchange rate *depreciation.* What this reveals is that Southeast Asian countries, during this period, were not hobbled by the presence of relatively high-cost productive sectors. To the contrary, their performance emphasized international competitiveness.

return than foreign currency-denominated assets. In all, domestic finance would be more costly than foreign finance. This reduces investment and undermines competitiveness.[12]

Factor Markets

Other than the international mobility of labor, countries are linked to one another via commercial bank loans and foreign direct investment (FDI). Commercial bank lending locks borrowers into debt service arrangements. Following the oil price rise in the early 1970s, this was the predominant modality of capital transfer to developing countries but it was curtailed sharply in the 1980s as a result of excessive bank equity exposure, and acute liquidity and solvency problems in Poland and the largest countries of Latin America. During the 1990s, although commercial bank inflows to developing countries have somewhat recovered (primarily propelled by financing from Japanese commercial banks and other financial entities extending credit to Southeast Asian countries), they have not reached the peak observed in 1980 (see Table 2.3).

FDI involves issues of ownership, management, and control of business units in host countries. It includes equity capital, re-invested earnings and intra-company loans and is attained by establishing a new subsidiary, by acquiring shares in an existing firm, and by participating in joint ventures. It can also be materialized through licensing of technologies and other intangible assets to firms in foreign countries. In general, FDI is rapidly becoming a major force for globalization of the world economy. In point of fact, the signs of increasing globalization through FDI are unequivocal (Table 2.5). In the 1960s it grew at a rate twice the GDP of the core countries, and while it declined in the second half of the 1970s largely as a result of the oil price rises, it reached unprecedented annual growth rates in the period 1986-90. In this period, FDI outflows increased at an average annual rate of 27%, three and five times faster than the growth of world exports and output respectively (Clegg 1996). Outflow growth continued at a somewhat slower pace in the 1990s, but in 1997 FDI posted another phenomenal year-on-year growth rate, just over 27% (Table 2.4).

There are several factors that explain this trend. First, the prime agents of this process, the MNEs, have expanded operations vigorously. In part, this results from increased competition within the core countries. This, of course, was something to be expected once the economic reconstruction of the industrial countries ravaged by the World War II was consolidated. In this regard, it is worth underlining the case of Japan. Starting in the late 1970s, MNEs based in this country undertook substantial investments in Southeast Asian countries, a trend that accelerated markedly during the second half of the 1980s with the substantial appreciation of the yen.[13] In addition, economic

[12] There is also a negative impact on income distribution. For example, in Argentina during the period 1989-95, a handful of large, well-established firms would obtain easy and relatively cheaper foreign finance. Small and medium-sized firms, many of which had excellent prospects to innovate and expand sales abroad, could only obtain finance from domestic banks, at much higher rates. Finance costs were so high that drove these firms out of foreign markets.

[13] The share on GDP of Japanese FDI inward plus outward stock rose from 2.2% in 1980 to 7.1% in 1990. In terms of world share of outward FDI stock, Japan's MNEs rose from 6.4% in 1985 to 11.8% (UNCTAD,

deregulation implemented since the early 1980s in the United States, and the ensuing faster growth of output, have increased the attractiveness of this country as a recipient of FDI from other core countries. Second, the expansion of the production of services has opened up new venues for FDI. As a result, MNEs no longer have to face the limits to growth that characterized the traditional industries, namely, natural resources and inward-oriented manufacturing. Third, developing countries in general have become more open and friendly to FDI. The turnaround has been spectacular, especially in Latin American countries, which long viewed MNEs as foreign economic agents that encroached upon their sovereignty. Since the 1980s, most of these countries have moved decisively to eliminate ownership restrictions, red tape and ceilings on profit and capital remittances, all of which are policies so characteristic of inward-oriented industrialization.[14]

Notwithstanding that developing countries have doubled their share of outward FDI stock in this decade, FDI is still driven primarily by developed country MNEs. Consequently, FDI flows are affected by the *business cycle* in core countries. In these countries, higher rates of income and economic growth, current account surpluses, and a decline in interest rates may increase FDI outflows. Conversely, recession at home coupled with rising finance costs dampen profits and thus limit the possibilities for expanding overseas. In the United States, for example, average annual FDI outflows amounted to $85.8 billion from 1993 to 1997, a period characterized by vigorous economic growth. This figure is substantially higher than the $25.7 billion posted in 1986-91, a period in the United States associated with higher demand for capital that was, in part, necessary to finance the fiscal deficit and wave of mergers and acquisitions within the private sector. The case of Japan is also very telling. In this country, because of sluggish economic growth and severe financial crisis, the annual average of FDI outflows have declined, from $33 billion in 1986-91 to $20.6 billion in 1993-97 (UNCTAD 1998).

The other determinants of FDI are to be found in the conditions of host countries. The first relates to macroeconomic stability. This includes an economic environment free of high inflation, and excessive interest and exchange rate fluctuations, as well as a reasonable expectation that balance of payments crises will not occur and that the burden of foreign debt can be reasonably managed. Another relates to expectations for high rates of economic growth and to the existence of economic conditions that may or may not be conducive to support MNEs strategies and expansion plans. For example, a country's comparative advantage in natural resources can be undermined by the poor quality and high costs of its economic infrastructure, while its inability to raise the educational standards and technical skills of its workforce makes it all but impossible to lure MNEs into launching productions tasks that go beyond simple assembling operations. Finally, the policy framework for FDI is a principal determinant. This includes the rules regarding

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1998). This share however has declined in the second half of this decade, probably attributed to the profound financial crisis that affects this country since the beginning of the decade.

[14] The debt crisis of the 1980s accounted for this *demarche*. Because of costly debt service payments and the reluctance of foreign commercial banks to lend fresh money, the Latin American region sustained negative transfer of capital resources and overall painful contraction of their economies. Policy makers of these countries did not lose sight of the fact that Asian countries, most notably South Korea, were also heavily indebted, but did not experience major problems because of their superior export performance.

entry and establishment, ownership, and operations;[15] treatment vis-a-vis domestically owned firms and abiding guidelines for the settlement of legal disputes; rules, if any, on local financing and dividend remittances; and tax and privatization policies.[16] Above all, the trade regime is a very important determinant. It sends signals on whether the host country is interested in inducing FDI to develop inward-oriented industrialization (via high tariffs) or to promote export-oriented industrialization (via a low level of import protection).

Goods Markets

Prior to the exponential expansion of international asset transactions, exports and imports of goods and services constituted the traditional linkage of countries with the rest of the world. Still, volume and value transactions have been steadily expanding. Since 1950, merchandise exports worldwide have grown two and a half times faster than world output. They have not grown as fast with respect to FDI (twelve times as fast in the case of the former, as opposed to sixteen times observed in FDI during the period 1973-1997). In all, international trade of goods and services does play an increasing role in the globalization of the world economy: in 1994-96 exports plus imports represented 41.2% of world output, significantly higher than the 8% posted in 1970-72 (UNCTAD, 1998). The principal reason lies in declining average tariffs observed worldwide since the 1960s, and in the gradual progress towards the elimination of non-tariff barriers to trade.

The following points are worth highlighting. First, exports in the overwhelming majority of developing countries still rely heavily on a handful of primary commodities. Their economies, consequently, are prone to suffering from often fluctuating if not deteriorating terms of trade. The second point relates to the faster expansion of trade in services, which partly reflects the structural shift in the economies of the developed countries. During 1980-95, trade in services grew at an annual average rate of 8%, higher than the 6% observed in merchandise trade. As a result, the share of service exports on total world exports has increased from 18% in 1980 to 20% in 1996 (World Bank 1998). Finally, since the 1970s there has been an expansion of trade within regional blocs. The most significant is the case of Mercosur. Launched in 1990, its within-bloc share rose from 9.4% to 22.1% in 1996 (World Bank 1998). To be sure, such a development suggests not only reduction of trade barriers within trade blocs but also an economic climate that may be more propitious for FDI. In point of fact, it is to be expected that

[15] A liberal policy framework would allow for easy entry, that is, just simple registration but not prior authorization approval; 100% ownership; and freedom to operate in any sector of the host economy.

[16] Tax policy is a vital determinant. Developing countries offer very generous tax holidays to lure FDI. For example, some Caribbean and Central American countries have offered income tax exemption for MNEs that assemble electronics parts in their territories. There is concern however that this may not be an effective incentive, for MNEs may be more amenable to tax stability and not to subsidies that may not last for economic and/or political reasons in the host countries. In Latin America, Peru is one country that has offered tax stability pacts to MNEs with apparent success. Privatization, on the other hand, has proven to be a powerful tool to attract FDI. Latin America, again, provides a useful illustration. FDI, and the process of economic recovery that started in the 1ate 1980s, was jump-started by the sell off of state owned enterprises to both domestic and foreign investors.

MNEs may in general be drawn to blocs that offer the advantage of larger markets. However, it does not necessarily follow that this will be conducive to trade-led, vigorous economic growth. Mercosur precisely is a case in point. Since its inception, this bloc has not managed to expand its trade with the rest of the world.

Multinational Enterprises

The next chapter discusses the determinants of MNE behavior. Here the increasing dominant role in the world economy that these entities play is underscored.

In 1997, assets of multinational enterprises were 6.7 times larger in value than that in 1982, and gross output of MNEs increased almost fourfold, increasing their share in world output. More tellingly, MNEs account for a substantial share of international trade. In 1995, exports of all MNEs represent almost one third of the value of world merchandise exports (UNCTAD 1998; World Bank 1998). A significant share then of world exports is conducted through either intra-firm trade or intra-industry trade.

MNEs are driven by different perceptions and expectations of host countries. First, they may be attracted by the potential volume and quality of natural resources (agricultural, mining and petroleum products), under the assumption that these commodities may be cheaper than if acquired or produced at the source. Second, they may target domestic markets. Unimpeded and preferential access to intermediate inputs and protection from foreign competitors are two of the policy tools that accompany this type of investment, which closely conforms to the strategy of promoting inward-oriented industrialization. Third, MNEs may choose countries as export platforms for the production of final and/or components of manufacturing goods, for which operating costs -- labor unit costs, public utilities, and transportation -- become key determinants. Last but not least, MNEs may seek to exploit opportunities in the services sector, such as transportation, marketing, distribution, finance, energy, and telecommunications. In this case, the focus is either in domestic or export markets.

Until the late-1960s, MNEs concentrated primarily on exploiting natural resources and on establishing subsidiaries to operate in domestic markets. However, since then the dynamism centers on expansion of services and on the production of manufacturing exports. In general, world FDI outflows in services are still primarily destined for developed host economies, while the NICs of Southeast Asia have an important share of export-oriented FDI stock. Both expansion of services and expansion of export-oriented FDI stock are closely interrelated. As more open trade regimes make business operations confined just to national markets less profitable, paving the way for increasing manufacturing oriented towards the world market, more profitable opportunities in the services sector evolve. Not surprisingly then, in the 1980s, it was possible in the developed countries to observe a shift in relative shares of outward FDI stock, away from

traditional manufacturing and towards services.[17] This shift has been accelerated by the decision of manufacturing-based MNEs to diversify operations into services, and by the process of economic deregulation enacted in host countries, both developed and developing.

The world economy is witnessing an increasing division between location of production and location of market. MNEs are leaders in effecting this division. More and more of these entities seem to be bent on shedding the traditional way of operation, i.e., the subsidiary located in a host country which would cater production only towards the local market, in favor a geographical dispersion of operations in which units or parts of MNEs become thoroughly specialized in the production of intermediate or final goods. This implies a process of "vertical disintegration" whose logic is to "reduce unnecessary duplication of production, thereby increasing productive efficiency and competitiveness, and to maximize the exploitation of comparative advantage" (Clegg 1996).

Challenges for Developing Countries

For developing countries to partake of the benefits that derive from the increasing globalization of the world economy, it is necessary that they be successful in promoting broad-based economic growth. This entails, at minimum, maintaining macroeconomic stability, controlling inflation, and encouraging high levels of domestic savings and investment. But it also requires strengthening the market linkages with the rest of the world. Given the likely disruptions to financial markets and the volatility of interest and real exchange rates induced by unfettered international asset transactions, it probably behooves these countries to be cautious and therefore to proceed to open their capital accounts gradually. But such caution can not be justified in the case of the other two linkages, namely, the goods and factor markets. As noted before, the overwhelming majority of developing countries have been largely by-passed by the process of outward-oriented FDI and accompanying closer integration with the world economy. Their trade linkages with the rest of the world still resemble those prevailing in Colonial times and their supply-capacity responses are very weak.

These countries need to embrace more open trade regimes, both to spur increased incomes and total factor productivity, and as a vehicle to induce outward-oriented FDI. In general terms, countries that have enacted more liberal trade regimes have posted higher rates of economic growth and have had better success in poverty alleviation than those that pursued inward-oriented development strategies (OECD 1998). For these very same reasons, they would benefit most by making their foreign investment regime less restrictive and, more importantly, by luring the "right" modality of FDI. This basically means steering away from policies aimed at promoting inward-oriented industrialization, such as high tariffs or domestic content requirements. Other than the fact that the

[17] See Clegg (1996). The major percentage shifts were recorded in the United Kingdom (12), Italy (18), Spain (23), the Netherlands (27) and Japan (28). More modest redirections were effected in Germany (11) and the United States (8).

efficiency-effect of these measures is suspect, this strategy makes FDI a partner for extending unwanted protection in local markets (Moran 1998).

In order to secure the maximum contribution of FDI to the host economies, steps must be taken to ensure that benefits that derive from FDI are higher than the resultant costs. This will occur when social returns are higher than private returns. Put simply, as long as FDI raises productivity, and this increase is not wholly appropriated by the foreign investor, the greater product must be shared within the economy among social groups (Meier 1976). The groups that would benefit include domestic labor, by way of greater employment and higher real wages that should result from increases in labor productivity; consumers, by way of lower prices; and the public sector, by way of larger tax collections. However, the most significant contribution of FDI is likely to come from the generation of external economies, in view of the fact that FDI brings critical resources that are in short supply: capital, foreign exchange, managerial ability, technical personnel, technological knowledge, administrative organization, innovation in product design and production techniques, upgrading of the labor force with new skills, etc. Furthermore, FDI may also serve as a powerful catalyst for the expansion of domestic investment through the generation of external pecuniary economies. In this vein, FDI can reduce supply costs and/or create demand in other industries, thus raising profits and encouraging new entry or expansion in domestic firms.

Against these benefits, the costs should be weighed. One that has often been mentioned is the possibility that domestic producers may be out-competed by MNEs and thus lead overall to lower incomes and savings in the host economy. In the same vein, it is also argued that FDI could elbow out domestic producers and substitute imported inputs, thus aggravating the foreign exchange shortage. It goes without saying that this is one of the most formidable obstacles that developing countries face. However, these concerns are arguably valid under strategies of inward-oriented industrialization, and therefore not applicable to outward industrialization. In point of fact, as the successful experiences of East and Southeast Asian countries demonstrates, rapid outward-industrialization, if anything, spurred the emergence of cadres of dynamic, innovative domestic entrepreneurs who are strategically linked not only with in-country MNEs but with affiliates and other parent companies around the world. And, as regards the foreign exchange issue, all that can be said is that it is precisely the ability to remedy balance of payments constraints which makes FDI most attractive, especially if it is oriented towards export expansion.

For all this to materialize, it requires from developing countries the adoption of comprehensive development strategies, which go way beyond the opening of free trade zones wherein MNEs enjoy extreme tax concessions and operate protected under special legislation. Normally, the attractiveness of these zones lies in their plentiful supply of unskilled labor, but the MNEs that set up shop in free trade zones are in the main “footloose” and exhibit very weak linkages with the rest of the host economy. The challenge is to upgrade the quality of the vital inputs of production -- labor, economic infrastructure, institutions, etc. -- that will make possible the attraction of FDI that carries the promise of the generation of higher value added.

3. Foreign Trade and Investment as Catalysts for Growth and Economic Development: Theory and Evidence

Neoclassical Theory

Globalization implies low if not eradicated barriers to trade and investment flows between countries, in the limit, giving rise to unified free markets for goods and services across national boundaries, including markets for services of productive resources such as capital and labor. Economic theory has long held that such an integrated world economy is the "first-best" outcome of international economic relations and an appropriate standard for policy analysis. These precepts are most commonly illustrated by fundamental theorems of neoclassical trade theory and the so-called Heckscher-Ohlin-Samuelson (HOS) model of international trade in which two countries produce and consume two goods (for final consumption) using two primary factors of production (capital and labor), assuming *inter alia* perfect competition and no barriers to entry in all (domestic) markets for goods and factor services. Indeed, in neoclassical trade theory unrestricted trade in goods, but not factor services, between the two countries (compared to an initial situation of autarky) results in not only greater welfare for both countries but also complete integration of markets for goods in the two countries.[18] In addition, unrestricted trade in goods results in not only equalization of relative goods prices in the two countries but also equalization of relative factor prices in the two countries (the so-called Stolper-Samuelson Theorem). That is, in the standard neoclassical model, free trade in goods results in factor price equalization as well as commodity price equalization across countries, with competing firms in the two countries adopting the same technologies and factor proportions in production of the two goods, ***as if*** the two countries were a single territory with unrestricted mobility of factors of production as well as goods.[19]

Neoclassical trade theory becomes more complex when initial circumstances are changed or more dimensions in terms of numbers of countries, numbers of goods, and numbers of factors are added to the HOS model. For instance, if the two countries are initially assumed to trade under protection, trade liberalization might not improve economic welfare of a "large" country, that is, a country that can influence its international terms of trade, to the detriment of other trading countries, by restricting its imports through applying an "optimal tariff" (Johnson 1953). Also, in multi-good, multi-factor models of international trade, comparative advantage is not always uniquely determined by simple measures of the relative abundance of primary factors of production among trading countries (Ethier 1984). Nonetheless, many precepts of the simple "2x2x2" HOS model are robust in more sophisticated neoclassical models of

[18] Greater welfare for both countries under free trade assumes possible compensatory payments to disadvantaged groups within one or both countries. Also under free trade, integration of markets for goods in the two countries assumes structural adjustment and unhindered mobility of factors of production within the two countries.

[19] See any intermediate-to-advanced textbook on international economics or trade theory, e.g., Krugman and Obstfeld (1991). For rigorous treatment, see Stolper and Samuelson (1941), Samuelson (1953), Jones (1956), Kemp (1969), and Dixit and Norman (1980).

international trade, including especially models describing the trade and welfare of "small" countries unable to influence their international terms of trade, which is the frequently assumed situation for LDCs and even many advanced countries. Many precepts are also upheld in neoclassical models of international trade incorporating intermediate (or inter-industry) goods – that is, goods produced for further input to production, analogous to goods "outsourced" by multinational enterprises in the emerging global economy (e.g., Kemp 1969, chapter 7).

In the neoclassical trade model, foreign direct investment is represented as a transfer of productive resources from one country to another. Typically, the transfer involves physical capital. However, it can also involve transfer of accompanying technology, management knowhow, and range of accounting, legal, and other professional services.[20] In the standard neoclassical trade model, such transfers of productive resources are equivalent to redrawing the dimensions of relative factor endowments among trading countries and hence to modifying if not entirely reshaping the dimensions of comparative advantage among countries. In a relatively capital-scarce country under protection and unchanged relative commodity prices, infusion of greater capital should be expected to reduce the relative price of capital, increase output of capital-intensive goods and reduce output of labor-intensive goods, and increase real wages.[21] Under free trade, a similar transfer of resources to a relatively capital-scarce country would be expected to have no effect on the country's relative returns to capital or labor, but it would be expected to influence the country's structure of production and trade. Specifically, the country would be expected to increase its output of capital-intensive goods and, accordingly, reduce its reliance on imports of such goods.

Among the most remarkable results of incorporating resource flows between countries in the standard neoclassical trade model is that mobility of primary factors of production between countries can substitute for mobility of goods between countries to achieve the same outcome as under free trade (Mundell 1957). Thus, unrestricted trade in resources can lead to the same first-best outcome as unrestricted trade in goods, namely, fully integrated markets for goods and factor services between countries.

In the real world, international flows of both goods and resources are typically limited by a variety of political restrictions, including tariffs, quantitative restrictions, and outright prohibitions.[22] Against the backdrop of the neoclassical model and assumed restrictions on both foreign trade and investment, trade and foreign direct investment have generally been considered substitutes. In particular, in circumstances in which countries maintain high levels of protection, foreign direct investment, where permitted, is very profitable to foreign investors, because through "tariff jumping" permits foreign investors to count on enjoying relatively high returns in sheltered markets. Host countries too can expect to reap benefits, namely, from the availability of greater capital, any accompanying new technology or knowhow transferred to the country, and, of course,

[20] Transfer of technology and knowhow from a "source country" to a "host country," it is important to mention, do not necessarily imply diminution of the store of technology or knowhow in the source country.
[21] This highly stylized result is known as the Rybczynski Theorem (Rybczynski 1955).
[22] They may also be limited by natural restrictions, such as distance between countries.

greater availability of goods produced -- the latter benefit, not unlike the benefit of admitting greater imports under trade liberalization.

Notwithstanding these benefits, the neoclassical theory of foreign direct investment is not attractive from a more normative as well as positive perspective. Economists have long criticized tariff-jumping because it tends to be geared to serving highly protected markets. In such circumstances, investment tend to be small-scale and inefficient by comparison to investment undertaken in more open economies, thus limiting the potential benefits of foreign direct investment. Also, from a political economy perspective, such inward-looking foreign direct investment tends to result in foreign firms in the host country joining local firms in supporting protection in order to safeguard the higher return on capital guaranteed by a sheltered market.

Finally, during the last two decades, foreign direct investment by multinational enterprises in relatively open East Asian developing countries has also raised questions about neoclassical trade models. In particular, it has been observed that foreign direct investment by multinational enterprises in East Asia has been decidedly outward-oriented, in terms of not only economic scale but also in terms of fitting host country comparative advantage and contributing to host country export performance. Thus, MNE investments in Hong Kong, Singapore, and several new Asian Tigers, such as Indonesia, Malaysia, and Thailand, have been often large-scale, undertaken in highly labor-using sectors such as apparel and assembly of electronic components, and oriented to production for international markets rather than solely host country or home country markets.[23]

Eclectic FDI Theory

Fundamental criticisms have been raised against neoclassical trade theory and its treatment of foreign direct investment during the last decade or more, culminating mainly in greater consideration of the implications of imperfect competition for international trade and investment under the general rubric of the so-called new trade theory pioneered by Krugman (1980) and others. Indeed, the central assumption of neoclassical trade theory that perfect competition exists in all markets for homogeneous (i.e., nondifferentiated) goods and factor services, with the result that firms should be expected to be predominantly atomistic and trade between countries should be expected to occur solely on an inter-industry, rather than intra-industry, basis has been subjected to considerable criticism. For instance, it is frequently upheld that intra-industry trade in differentiated products occurs widely in the real world, especially between advanced countries, and that modern multinational enterprises, by virtue of their large size, bear greater resemblance to imperfect competitors rather than perfect competitors and hence potentially contribute adversely to national and global economic welfare (by maintaining higher prices and lower output than socially desirable). Also, to the extent that foreign direct investment frequently gives rise to intra-firm trade by MNEs, the absence of

[23] For further discussion of establishment of "export platforms" by multinational enterprises in East Asia, see Petri (1992, 1995) and World Bank (1993, 1994).

"arm's-length" transactions in the process of outsourcing by MNEs in the global economy is also considered at odds with the neoclasssical assumptions of not only perfect competition but also equal knowledge and access to production technologies by competing firms in all trading countries – assumptions which would argue for existence of more formal markets for intermediate goods produced by MNEs and greater entry to such markets by local firms in host countries.

With its emphasis on incorporating imperfect competition into the general equilibrium framework of neoclassical trade theory, the new trade theory has yielded some useful insights but failed to supplant neoclassical trade theory entirely, especially in connection with early new trade theory prescriptions for greater government intervention in international trade under the rubric of "strategic trade policy" (Krugman 1987; Brander 1995). At the same time, foreign direct investment theory continues to be heavily influenced by the new trade theory and firm-level considerations, following early work on multinational enterprises and foreign direct investment by Hymer (1960), early work on transactions costs and firm behavior by Coase (1937), and new trade theory contributions to understanding the behavior of MNEs and its effect on trade, industry, and international competition (Helpman 1984; Helpman and Krugman 1985). These include considerations for MNE behavior under imperfect competition; MNE proprietary ownership of assets – including especially location advantages, production and management technologies, and firm-specific knowhow; and incomplete markets for immediate goods embodying new or advanced technologies – including new or advanced production technologies.

Thus, today the theory of multinational enterprise behavior and foreign direct investment is essentially eclectic. Dunning (1981, 1993) describes the current consensus theory as the OLI paradigm, referring the often intertwined importance of firm-specific advantages (O) such as market power derived from product differentiation, scale economies, proprietary technologies, or government favor (e.g., protection from foreign competition) secured through rent-seeking, traditional locational or HOS-type comparative advantages (L) owing, for instance, to differences in relative factor endowments among countries, and so-called internalization incentive advantages (I) which refer to behavior by firms to produce intermediate goods or undertake other activities internally rather than procure them through formal markets in which transactions at arm's-length would be expected to prevail.[24] The OLI paradigm applies to foreign direct investment by MNEs to achieve either horizontal or vertical integration of their activities worldwide.[25]

With regard to globalization and less developed countries, recent trends in FDI indicate extensive outsourcing by MNEs of intermediate products from less developed countries, as part of vertical integration by MNEs of their production and distribution

[24] Notably, no formal markets or only "thin" markets may exist for production or distribution of goods involving new technologies or processes, encouraging if not requiring multinational enterprises to internalize some FDI and other activities.

[25] Foreign direct investment by multinational enterprises to achieve greater diversification of activities or assets is not considered here. See, for instance, Caves (1996) for discussion of MNEs and diversification.

activities. In this connection, the OLI paradigm points to the importance of firm-specific factors such as proprietary assets and, arguably, thin markets for immediate goods that must be produced to higher technology or other standards than commonly found in less developed countries. At the same time, it also points to traditional neoclassical considerations, especially comparative advantage factors, such as the relative abundance of labor and lower real wages in many less developed countries. Finally, it points to the stance of economic policy regimes in would-be host countries. While stability of macroeconomic policies and legal safeguards for private property rights are vital, the openness of trade and other external economic policies is also of prime concern. In the new global economy, trade and foreign direct investment have come to be viewed as complements rather than substitutes. That is, given the global perspective of many multinational enterprises today, foreign direct investment opportunities are increasingly judged by their potential for outward-oriented production and distribution of products, befitting either vertical or horizontal integration objectives of MNEs serving predominantly large-scale international markets.[26]

Thus, the OLI theory of foreign direct investment encompasses the neoclassical view that export performance can be substantially hindered by the host country's own policies towards imports. Host country protection measures, such as tariffs, quantitative restrictions, and even non-border measures such as industrial or qualitative standards for goods and services that apply effectively only to imports, actually restrict the ability of producers in the host country to sell goods abroad competitively well beyond the direct impediments that protection can impose on producers, such as restrictive measures applied to essential imported inputs to production. As Lerner (1936) outlined over half a century ago, and, among others, Clements and Sjaatad (1984) and DeRosa (1992) have argued more recently, tariffs and other restrictive import measures are a tax on exports. In the new global economy, protection is a hindrance to attracting outward-oriented foreign direct investment.

Many questions concerning the national welfare of host countries have come to the fore in connection with internalization of MNE production and distribution activities. For instance, that desired new technologies and managerial skills may not be transferred widely to local producers in host LDCs is sometimes blamed on the desire of MNEs to safeguard their proprietary assets while taking full advantage of location advantages in less developed countries such as low wages for unskilled labor. However, other, adverse location factors may also be important and, if remedied, would help contribute to greater diffusion of benefits under foreign direct investment.

For example, under more liberal trade policies, host country producers and consumers might allocate domestic resources more efficiently, including their own labor. Host country producers in particular would tend to adopt technologies that are more appropriate to not only their own economic circumstances but also economic

[26] Tariff-jumping foreign direct investment may still be attractive to MNEs, of course, where domestic markets in LDCs are especially large (e.g., China) or where protection is sufficiently high to guarantee exceptional profits to MNEs in exchange for their undertaking inward-oriented (and, typically, small-scale) foreign direct investment (e.g., auto-assembly plants exclusively for local market).

circumstances prevailing internationally. These tendencies would help ensure that the greatest output for available domestic resources would be attained, maximizing a country's economic growth, development, and welfare, led in many instances by robust export performance. From this perspective, however, strong export performance sustained by a liberal trade policy regime is a "handmaiden" rather than an "engine" of economic growth.[27]

In this last vein, it is important to emphasize that foreign direct investment is widely regarded today to be vital for economic growth and development in less developed countries. Economic growth and development, of course, are related to many dynamic factors, among the most important of which are growth in labor, physical capital, and technology (including general knowledge and managerial knowhow) as input to aggregate production. Growth of labor is frequently considered given by nature, but it may be importantly subject to economic policies impinging on employment as well as population growth. Growth of physical capital and technology inputs is more often considered subject to changes in economic circumstances and especially changes in economic policies. Traditionally, domestic investment has been a particular focal point of economic growth theories. However, with the advent of the so-called new growth theory, factors influencing growth of technology, general knowledge, and managerial and technical knowhow have come to the fore in attempts to understand why countries grow and develop at different rates over long periods of time (Barro and Sala-i-Martin 1995).

Multinational corporations often command highly valuable production, management, and marketing skills and technologies. Hence, in addition to FDI-related gains in resource allocation and static efficiency, host countries are often anxious to benefit from "technology transfers" accompanying direct investment by multinational corporations. Broadly speaking, to the extent that they become diffused widely in the economy, such technology transfers are expected to enhance economic growth through gains in “total factor productivity,” especially in export sectors where gains in total factor productivity may be readily apparent in discernible gains in international competitiveness.[28]

This seems to have been the case for many East Asian countries embracing foreign direct investment. However, even for these countries, questions have been raised about the appropriateness of host country economic policies and institutional arrangements surrounding foreign direct investment, and about the extent to which the benefits of foreign direct investment in these countries were diffused widely in the local

[27] See Kravis (1970) and Riedel (1984). On the general issue of export performance and growth, there is considerable quantitative and empirical evidence in support of the proposition that export growth contributes appreciably to economic growth and development in developing countries.

[28] As emphasized by Krugman (1994, 1996), the competitiveness of countries is much different than the competitiveness of firms. Whereas the competitiveness of an individual firm is often achieved at the expensive of the output of a less efficient and profitable competing firm, the competitiveness of a country is achieved at no or little cost to other countries and, in fact, most often adds to world welfare. Fundamentally, international competitiveness is defined as the ability of a country to produce goods and services that meet the test of international markets and simultaneously to maintain and expand the real income of its citizens (Tyson 1993; Ostry 1991).

economy. Indeed, these questions are a central element of the so-called contrarian view of the East Asian Miracle which holds that the astonishing growth record of the East Asian newly industrialized countries reflects mostly high growth of physical inputs to production and comparatively little growth of total factor productivity.[29]

Host Country Policies

By comparison to trade policies and practices, economic policies regulating foreign direct investment in most LDCs are more stringent. Although a number of bilateral agreements to improve conditions for investment by firms of each signatory country in the other country have been signed by LDCs, especially with the major industrial countries, no multilateral agreement exists today to provide principles of behavior for host countries, such as national treatment or nondiscrimination among foreign investors, kin to similar principles covering trade in goods under the General Agreement on Tariffs and Trade (GATT).[30]

Most developing countries have evolved public policies to control and selectively encourage foreign direct investment and technology transfer, often under the authority of an official agency responsible for reviewing foreign investment proposals, especially large-scale foreign investments in "greenfield" production plants or sales facilities. These public policies cover establishment of export processing zones (EPZs); extension of special tax holidays and other financial inducements – including special exemptions from import duties on capital goods and production inputs; and even provision of investment grants and subsidized credits. In many instances, they also include mandated "performance requirements," especially requirements for minimum joint ownership by host country residents and requirements for meeting quantitative targets for exports or purchasing local inputs (including labor services).[31]

Controversy surrounds the efficacy of official inducements to attract foreign direct investment relative to economic fundamentals such as the general trade and macroeconomic policy environment of the host country. Concerns for proliferation of official inducements, and for their budgetary costs, have widely prompted proposals to place limits on foreign direct investment policies and practices by multinational corporations, their home countries, and host countries.[32] As previously mentioned,

[29] See Young (1993, 1994) and Krugman (1994). On the East Asian Miracle, see World Bank (1993).

[30] The Uruguay Round Agreement ratified in 1994/95 provided for some curbs on restrictive foreign investment policies under the rubric of “trade-related investment measures.” Since the conclusion of the Uruguay Round, a multilateral agreement on investment (MAI) has been under negotiation among the major industrial countries but, to date, without certain conclusion. This has prompted calls for a change of venue in the MAI negotiations, from the Organization for Economic Cooperation and Development to the World Trade Organization.

[31] For more extensive discussion of restrictions on foreign direct investment and their rationale, see for instance Guisinger (1985) and IFC (1997).

[32] Graham (1994) and Soesastro (1996) discuss proposals for limiting competitive foreign direct investment policies and practices in the Asia-Pacific region. For a review of proposed multilateral agreements covering competitive foreign direct investment policies and practices, see WTO (1996) and Graham (1996).

bilateral investment agreements are to be found frequently between advanced countries, such as the United States, Japan, and the European Union countries, and their principal trading partners in developing regions. And, as part of the Uruguay Round Agreement, some modest steps towards curbing trade-distorting effects of national investment codes and regulations governing foreign direct investment (so-called trade-related investment measures (TRIMs)), were taken (Schott 1994). However, with a view to the future, greater strides towards achieving GATT-like principles of national treatment for foreign investors and nondiscrimination among foreign investors might be expected from multilateral negotiations, begun in 1995 under the auspices of the Organization for Economic Cooperation and Development (OECD), to establish a comprehensive framework for treatment of foreign investment, to be known as the Multilateral Agreement on Investment (MAI).[33]

It should also be emphasized that, because foreign direct investment and technology transfer occur at the firm level, any significant impact on the host country economy and its international competitiveness must involve diffusion, or "spillovers," of the benefits of foreign direct investment to the general economy and especially productivity of the labor force and manufacturing sector. Consider, for instance, the impact of FDI flows attracted by export processing zones. By their nature, EPZs provide a free trade environment but one that does not extend beyond the zone's physical boundaries. Although firms operating within the free trade zone might tend to be internationally competitive, the larger number of domestic firms and even foreign-owned firms operating in the host country outside the free trade zone may face little effective discipline from international competition unless free trade and other open economic policies are extended beyond the boundaries of the free trade zone to the general economy.

Finally, the contrarian view of the growth experience of developing East Asian countries suggests that economic policies and institutional arrangements more conducive to ensuring significant spillover effects from foreign direct investment, such as low barriers to market entry, minimal performance requirements on foreign direct investment projects, and other policies and institutional arrangements to achieve, and maintain, largely unfettered markets and equally unfettered competition among extisting and potential rival enterprises (increasingly referred to as “competition policy”),[34] would help ensure the greatest diffusion of productivity, technology, and other long-term benefits from foreign direct investment in host countries. Another is pursuing institutional and policy reforms to improve private and social investment in education, and continual upgrading of labor and management skills, in order to realize sustained high returns (rather than declining returns) to investment projects, following the "new growth theory" propounded by, among others, Roemer (1986, 1990) and Lucas (1988).

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[33] Although MAI is being negotiated among 29 OECD member countries and the European Union, a number of observers are involved, including official representatives of Argentina, Brazil, Chile, Hong Kong, and the World Trade Organization. On completion, MAI will be open to signature by OECD countries and non-OECD countries alike.

[34] See, for instance, Graham and Richardson (1997) and WTO (1997).

Evidence from Economic Studies

Before turning in the next section to consider the experience of Egypt and similar developing countries with foreign direct investment, trade, and growth, this section concludes with highlights from the findings of recent empirical studies of foreign direct investment and its impacts on trade and growth in developing countries, based on the experiences of a wider variety of less developed countries. Fortunately in this connection, the World Trade Organization and Institute for International Economics have undertaken two recent, extensive reviews of empirical studies on foreign direct investment and its impacts on host country trade, growth, and economic development.

Broadly speaking, the WTO review (WTO 1996) supports the view that foreign direct investment (FDI) contributes to improving international competitiveness and economic growth in developing countries. The major findings of the WTO review are:

1. Foreign direct investment and host country exports are generally complements, in not only mining and other natural resource-based industries (in which output tends inherently to be export-oriented) but also a broader range of industries. Also, foreign-owned manufacturing firms tend to export a greater proportion of output than do their locally-owned counterparts, presumably owing to their greater knowledge about international markets, their typically larger scale and efficiency in production and marketing, and their greater ability to respond quickly to changing patterns of demand in world markets. Finally, entry by foreign firms also tends to promote increased exports by domestic manufacturing firms.[35]

2. New technologies are introduced abroad primarily through production by subsidiaries of multinational enterprises rather than exports produced by multinational corporations in their home country, owing to *de facto* globalization of production and intra-firm research and development (R&D) activities of multinational enterprises.[36] Also, technology transferred through foreign direct investment tends to be newer than technology transferred through licensing agreements and joint ventures.[37]

3. In manufacturing sectors, direct investment by foreign firms tends to increase the productivity of locally-owned firms, increasing the rate of productivity convergence toward the level in the corresponding industry of the MNE home country. [38]

[35] See Hill (1990) and, for example, Aiken et al. (1994).
[36] This finding is contrary to the heretofore dominant product cycle theory of international trade and investment advanced by Vernon (1966), which essentially maintained that new technologies, especially production technologies, would tend to be transferred from advanced source countries to less developed host countries only after product maturation or standardization occur.
[37] See Mansfield et al. (1982, 1987) and Mansfield and Romeo (1980).
[38] Blomstrom and Persson (1983), Blomstrom (1986), Caves (1974), and Globerman (1979).

> 4. Foreign direct investment frequently stimulates competition, productivity, and innovation by local suppliers, as local suppliers vie for lucrative contracts with multinational enterprises that seek to integrate their foreign operations vertically in host countries.[39] Most important, in host countries with greater labor skills, lower barriers to market entry, and less stringent performance requirements on foreign direct investment, the transfer of advanced technologies to local subsidiaries by foreign parent firms tends to be larger, and the gains in industry-wide productivity tend to be greater.[40]
>
> 5. Finally, foreign direct investment has a substantial, positive effect on macroeconomic growth, particularly when the host country has abundant stocks of human capital and skilled labor.[41] That is, foreign direct investment has particularly significant spillover effects on industry and economywide growth when the host country has adopted economic policies and institutions that not only favor provision of appropriate social infrastructure (e.g., transportation and communication networks) and legal protection for free commerce and private property rights, but also favor the provision of manpower training and higher education.[42]

Remarkably, these findings are upheld, in the main, by a second recent review of evidence on foreign direct investment and its impacts on less developed countries, undertaken for the Institute for International Economics by Theodore Moran (1998). Specifically, this latest review considers evidence on the impacts of foreign direct investment drawn from studies of three prominent industries in the global economy: petrochemicals, autos, and electronic/computer equipment.

In addition to reinforcing many of the previously enumerated "positive" findings, the Moran study emphasizes some consistent "negative" findings. These negative findings go to the familiar point that host countries that succeed in attracting sub-scale foreign investment by multinational enterprises, through combinations of protection, inappropriate tax and other fiscal incentives, and performance requirements (including constraints on foreign ownership of resources), typically generate appreciable inefficiencies and misallocation of resources in the host country, with constrained foreign firms exhibiting older technology and business practices than unconstrained foreign firms in other countries and, more often than not, leaving the host country worse off than if it had never received the investment in the first place. According the Moran, such negative outcomes create

> a vicious dynamic of adverse signals and perverse incentive (both economic and political) for all parties. Instead of providing a path for growth, dynamic

[39] See Lim and Pang (1977, 1982) and Halbach (1989).
[40] Blomstrom, Kokko, and Zejan (1992), Kokko (1994), and Kokko and Blomstrom (1995).
[41] See Borensztein, De Gregorio, and Lee (1998), and Blomstrom, Lipsey, and Zejan (1996).
[42] This finding by the recent empirical and case studies reviewed by the WTO study is consistent with the "new growth theory" propounded by, among others, Roemer (1986, 1990) and Lucas (1988), which argues that sustained growth at a high rate requires increasing returns to investment achieved through, for instance, endogenous technical change or education.

> learning, and development, this FDI tends to produce stasis and conflict, generating constituents that are likely to use their influence to maintain their privileged position and undermine the impetus for economic reform. (Moran 1998, p. 156)

Finally, Moran raises a last caution in regard to growing competition for foreign direct investment among LDCs, pursued through tax incentives and other fiscal subsidies. Specifically, he points to not only increasing use of similar subsidies by advanced industrial countries in counteroffensive to maintain MNE production facilities in home countries, but also increasing use of administered trade measures by advanced countries, such as rules of origin under regional trade agreements and anitdumping regulations, to hinder relocation of MNE production facilities to more efficient sites in less developed countries.

In truth, the last caution raised by Moran is one that should be directed equally to advanced countries, as it threatens efficiency and growth in not just less developed countries but also the entire new global economy. As such, it argues perhaps more strongly than other recent arguments for more intensive negotiations to establish a truly multilateral agreement on investment, under either the OECD, WTO, or an ad hoc secretariat for multilateral investment negotiations not unlike the secretariat that successfully served the General Agreement on Tariffs and Trade, and several rounds of multilateral trade negotiations, for over 40 years (Krueger 1998).

4. Experience of Egypt and Other Less Developed Emerging-Market Countries

Middle East and North Africa

Egypt

Egypt's economic size and geographic position are attractive to many international investors. At the same time, the Government of Egypt (GOE) is cognoscente of the desirable effects that foreign direct investment could have on the domestic economy. Despite Egypt's advantages and steps taken by the Government to encourage foreign direct investment, FDI levels have fallen short of private and official expectations. In this subsection, the status of FDI in Egypt is reviewed, in regards to FDI trends, the business and policy environment, and the role of FDI in integrating the Egyptian economy into the global world. In the following subsection, FDI in Egypt is explored in a comparative perspective vis-à-vis other prominent countries in MENA.

FDI Trends and Current Status. Encouraging FDI has been a key target of the Egyptian government since the opening of the Egyptian economy in 1974. Since then many policy measures have been formulated and implemented to attract FDI. Table 4.1 traces the trend of FDI since 1974.

Two waves or cycles of FDI flows in Egypt can be identified. The first wave started during the mid-1970s, with the opening of the economy. By international standards, Egypt received relatively high flows of FDI during the 1970s, as seen in Table 4.2 which shows the top 10 developing economies in attracting FDI since 1970.

According to many analysts, high inflows of FDI to Egypt were attracted by the highly protected and large market size of the Egyptian economy (Mahboub 1998, Soliman and Abdel-Latif 1996, INP 1996, AmCham 1995, FIAS 1991). In a questionnaire conducted by the American Chamber of Commerce of Egypt (AmCham 1995), it was found that almost 50% of American firms that located in Egypt targeted the local market, only 15% intended to export. Also, as Table 4.3 shows, a high proportion of these companies consists of agents and distributors who do not participate in production.

A recent study undertaken for the Egyptian Ministry of Trade and Supply (DEPRA 1998b) showed that there is a big difference between nominal and effective rates of protection in Egypt, encouraging tariff-jumping foreign direct investment in especially those sectors with high effective rates of protection (Table 4.4).

From this perspective, the relative slowdown of FDI inflows to the Egyptian economy during the 1980s, and actual decline in the level of these flows during the first half of the 1990s, can be explained by the stagnation and decline in growth rates of the economy during 1980-95. A recent study by Abdel-Latif (1998) tested the relation between the size of the economy and FDI inflows in Egypt. It found a high correlation

between these two variables in Egypt for three successive periods during the 15-year period ending in 1995, as shown in Table 4.5.

The second wave of relatively high FDI inflows started during the mid-1990s. Many economic observers have explained this wave in connection with the onset of the privatization program in Egypt. As explained in a recent review of the Egyptian economy, "the ability of Egypt to attract foreign capital has been greatly facilitated by progress in privatization during 1998. That year, according to the Ministry of Finance, Egypt attracted 40 percent more FDI than the year before" (AmCham 1998, p. 21). In this connection, the Central Bank of Egypt reports that net foreign direct investment in Egypt rose to $1,108 million during 1997/98, compared to $770 million during the previous year (CBE 1998).

Concerning the sectoral composition of foreign direct investment, FIAS (1991) and, more recently, Mahboub (1998) report that there exists no comprehensive set of data to support investigation and analysis of the sectoral composition of actual FDI in Egypt. Therefore, all analyses must rely on information about long-term foreign investment in Egypt drawn from relatively sketchy reports on approved projects by the General Authority for Investment (GAFI). Outside the petroleum sector, manufacturing activities appear to be favored most by FDI flows to Egypt, as seen in Table 4.6. Table 4.7 reveals that chemical products have the highest share of FDI in the manufacturing industry.

National origin of FDI flows to Egypt has not been a topic of major concern. According to FIAS (1991), Arab investors constitute the big portion of FDI in Egypt, followed by American and European investors. Investors from Far East countries are minor. Future studies might usefully analyze the effect of Egyptian joint ventures with US and EU multinational enterprises. Also, some economic analysts anticipate future big inflows of FDI from Far East countries to Egypt, to share in the benefits of free trade under the Mediterranean free trade initiative of the European Union (CEFRS 1997). However, the "hub-and-spoke" design of the bilateral Euro-Med agreements negotiated to date between the European Union, on the one hand, and several individual MENA countries, on the other hand, might tend to concentrate investment in the hub country (i.e., European Union) rather than spoke countries such as Egypt.

Business and Policy Environment. Many economic studies have analyzed the business and policy environment for FDI in Egypt (IMR 1998, Fawzy 1998, Mahboub 1998, Soliman, Abdel-Khalek et al. 1998, DEPRA 1997, ERF 1997, Soliman, Abdel-latif et al. 1996, AmCham 1995 1994, and FIAS 1991). These studies reveal that there is considerable consensus about the positive and negative aspects of the environment for foreign direct investment in Egypt.

The open door policy adopted in Egypt in 1974 attempted a gradual reorientation of economic policies to promote the participation of private sector in the economy. The issuance of the Investment Law of 1974 marked the outset of many related laws and national legislation that encouraged inflows of FDI in order to inject investment and new technology to the economy. In 1991, liberalization of the exchange control system was

begun, to permit private businesses and individuals to hold their own foreign exchange in bank accounts, and thereby allowed creation of a free foreign exchange market. Liberalization of the foreign exchange market culminated during the early-1990s in the complete convertibility of the Egyptian pound. The Investment Law of 1974 was amended many times and replaced by Law 230 of 1989, and finally by the new Unified Investment Law, Law 8 of 1997. These changes and modifications to investment laws in Egypt have provided support and encouragement for FDI in the economy. At the same time, the government began constructing a series of five public free trade zones, to provide private investment still more incentives and freedom of work.[43]

Today, FDI in Egypt faces no limitations regarding foreign equity shares in Egyptian enterprises. Also, it faces no performance requirements in terms of mandatory production or exports, domestic content of goods, or foreign exchange balancing. However, as discussed further below, Egypt does continue to place restrictions on the extent of allowable expatriate employment by MNEs, and requirements for mandatory employment and minimum wages for Egyptian workers (the latter a requirement for all licensed companies in Egypt).

Finally, an important point to note is that Egypt's current stance towards foreign direct investment is designed to encourage inflows of "traditional" FDI, or in other words, inflows of long-term capital for establishment of turnkey facilities. Attention to the importance of non-traditional forms of FDI, such as shares in equity of Egyptian firms in exchange for access to new management, knowhow, or technology supplied by foreign firms, has been recognized and discussed only recently, for example, in connection with formulation of [a new trade law and] amendments to the Egyptian commercial codes.

The following points summarize major aspects of recent reforms to Egyptian law which are especially relevant to FDI decisions:

National Treatment

Foreign firms receive equal treatment under investment laws and general business rules and regulations as domestic firms, except for a few strategic industries (e.g., arms and munitions) in which foreign participation is prohibited. Language distinguishing among "foreign," "Arab," and "Egyptian" investment entities, commonly found in prior laws, is eliminated in New Investment Law 8/1997.

Repatriation of Profits and Capital

Foreign investors are permitted to repatriate profits realized in Egypt, subject to some remaining but generally easy to satisfy requirements for approval. The new Unified Investment Law, Law 8 of 1997, does not include any provisions guaranteeing the right of foreign firms to freely repatriate capital, which might be seen as a weakness. However, the Promulgating Decree of the New Investment

[43] In addition to public free trade zones, a number of "private" free trade zones dedicated to the storage, processing, or other operating needs of individual industrial firms have been established in Egypt, at Cairo, Alexandria, Port Said, Suez, and Damietta (INP 1996).

Law 8/1997 takes note of Law 38/1994, which allows companies to covert currency as needed.

Performance Requirements
Investment performance requirements have been reduced, although Egypt still places restrictions on hiring expatriate employees relative to Egyptian employees. Though not required, local content requirements are specified for some industries, such as auto manufacturing, in order for domestic and foreign firms to qualify for additional tariff reductions on imported inputs.[44]

Guarantees against Ex/Recourse to Independence
New Investment Law 8/1997 provides guarantees for foreign investors against expropriation of business property and assets. Foreign investors may appeal to independent international arbitration bodies in property right disputes with the government. Also, Egypt is a signatory to numerous bilateral investment treaties, which provide for such arbitration mechanisms. With regard to trade disputes, Egypt recently became a signatory to the General Agreement on Tariffs and Trade and a member of the World Trade Organization.

Intellectual Property Rights
Egypt has increased enforcement of laws and regulations regarding intellectual property rights, with particular focus on enforcing intellectual property rights for musical recordings and movies.

Tax Incentives
Through new stipulations in law, Egypt's system of tax incentives for foreign direct investment has been made more transparent and automatic.[45] However, implementation and especially adjudication of Egypt's tax laws remain cumbersome and require reforms for procedural clarity and automaticity.

Technology Transfers under Equity Exchanges
Proposals for a new trade law and amendments to Egyptian commercial codes provide Egyptian companies with greater flexibility to cooperate with foreign firms in the realm of transfer of technology including especially in connection with exchanging foreign technology for equity shares in domestic enterprises.

Notwithstanding these improvements to the policy environment for foreign direct investment in Egypt, many foreign enterprises interested in investing in Egypt continue to be wary of the general business and policy environment for both foreign and general domestic investment in Egypt. This is attributed to a number of factors:

Policy Predictability and Macroeconomic Sustainability

[44] Although this practice does not violate the WTO agreement on trade-related investment measures (TRIMs), it is prohibited under the WTO agreement on subsidies and countervailing measures.
[45] See Table 4.11 for details about tax incentives for foreign direct investment under Egyptian law.

Large private companies have better contacts with policy makers than small enterprises. Also, the average Egyptian entrepreneur is often unable to obtain more than partial information about forthcoming policy changes, such as energy price adjustments, modifications to the trade regime, and changes in wage and labor laws. In addition, private sector confidence in the economy and prospects for investment are dampened by uncertain aspects of the macroeconomic environment, such as the fixed exchange rate system combined with continued domestic inflation, uncertain prospects for continued high levels of foreign aid, and continued sizable if not rapid accumulation of domestic public debt under social pressures for expansion of public expenditures (AmCham 1994). By many accounts, however, the importance of these impediments is decreasing as Egypt's record of prudent macroeconomic stabilization continues to be upheld.

Legal and Regulatory Systems

Legal and regulatory systems in Egypt are time and effort consuming. Needed are "one-stop-shop" investment centers (such as in the Philippines) where foreign investors can meet and deal with all relevant authorities, and obtain all necessary investment clearances and approvals.

In general, the approval procedure for foreign direct investment projects in Egypt is lengthy because of the multiplicity of agencies involved. Also, differences in attitudes toward foreign investors by different government offices and ministries are considered another major impediment. For example, the time involved for FDI and business establishment approval can range from 3 to 6 months (FIAS 1998).

Egypt's governmental structure carries with it a heavy bureaucratic legacy. This reflects past reliance on central planning and government control. Such a structure does not change automatically as major economic policies are reformed, and in many instances it forms the primary constraint to attaining greater levels of investment, both by domestic investors and foreign investors. Among the many bureaucratic bottlenecks facing investors, three "choke points" would seem to require priority attention: company incorporation and registration; site development and establishment and operation (E&O) licensing; and purchase or rental of land for investment projects. Efforts to remove these constraints would substantially improve Egypt's business environment, and provide the country with greater opportunities for gaining a competitive position vis-a-vis other countries worldwide.

Also in the legal and regulatory area, notwithstanding recent increases in foreign direct investment attributable to privatization (AmCham 1998, p. 21), impediments to divestiture of state-owned enterprises still exist and hinder greater inflows of foreign direct investment (DEPRA 1997):

-- Lack of a coherent schedule for privatization as well as the unavailability of credible public information regarding the assets and balance sheets of state-owned enterprises (SOEs) scheduled for privatization;

-- Occasionally stated government preference for domestic private investment in certain sectors slated for privatization;

-- Decision by the government not to include land in the selling package for a number of public sector companies. (The government indicated it would, in some cases such as the public offering for Al-Ahram Beverage Company, allow land title to revert to the holding company after five years.)

-- Government emphasis on minimizing social unrest in connection with restructuring to eliminate redundant labor to achieve increased productivity and competitiveness;

-- Sales allocation system for shares in privatized firms whereby sales of company shares are subject to limitations in order to meet widespread demand for shares, thus fragmenting new ownership and preventing more effective new management;

-- Concerns expressed about government methodologies for valuation of SOEs and their assets.

-- Lack of a facilitating legal and regulatory framework to support privatization by remedying adverse tax, labor, and housing laws; protection of monopolies; and stifling levels of bureaucratic intervention and delays;

-- Inefficient securities settlement, registration, and custody regulations and facilities;

-- Unsettled debt load and other liabilities accompanying many SOEs; and

--Government inability, owing to scarce financial and human resources, to restructure SOEs adequately to make them more attractive to private investors.

Judicial System

Problems of the judicial system involve litigation procedures, understaffing of the court system, low technical capacity of lawyers and court clerks, poor judicial facilities, and limited financial resources. As a result, litigation in Egypt is expensive and time consuming (AmCham 1994).

Finance

The securities market does not yet play a significant role in private corporate finance in Egypt.

Human Resources and Social Infrastructure

Foreign investors are concerned for the quality of human resources and social infrastructure in Egypt. With regard to human resources, they often judge that Egypt is deficient in vocational training and is lacking in adequate human resource development, both at the working-class level and managerial level.

Egypt's infrastructure is moderately well developed, but its operation and maintenance are generally inefficient and high cost, because it is dominated by state monopolies. Large future investments will be required for modernizing, upgrading, and expanding telecommunications, electric grid and networks, air and sea ports, and rail and vehicle roadways. The Government may invite private sector participation in a variety of ways: through concessions and management contracts, privatization, and investments in new infrastructure on a build-operate-transfer or build-own-operate basis. But, so far, the government has not aggressively promoted private investment in infrastructure by either domestic or foreign investors (DEPRA 1997).

Tax Administration

In Egypt, a business may not know the full extent of its tax burden until a number of years after submitting a tax declaration. The tax authorities follow a policy of complete, rather than selective, auditing of businesses and firms.

There is a five-year limit for tax holidays on many new investments, and, as a result, investors often submit unfounded claims in order to trigger a second, five-year period of exemption from taxation. Also, tax rates are very high on corporate profits and personal income, although tax holidays are common for larger firms. In effect, the process of tax assessment and collection is a time-consuming and costly bargaining process. Not surprisingly, a large number of tax assessments end up waiting for court resolution, and tax underreporting or evasion are widespread (AmCham 1994).

Before enactment of the new Unified Investment Law, Law 8 of 1997, foreign firms doing business in Egypt usually chose to incorporate under legal forms that are granted special tax holidays (Law 230 of 1989). However, such incorporation is by no means simple. The actual duration of tax holidays is not clear in many instances. Foreign firms appear to count on the possibility of renewals or re-incorporation. Tax holiday complications usually continue after the original approval. For instance, if a firm chooses to diversify or to eliminate certain activities, a new tax exemption must be obtained, and separate records must be kept for any new capital investment (to show revenues associated with the new investment and to apply appropriate tax exemptions).

Overall, the time-consuming, inefficient process of filing tax returns adds an important element of uncertainty to private business planning in Egypt. The Government has started a process of reform to improve the tax collection system (supported by USAID); however, the effort is currently limited to the newly

introduced sales tax, which is applicable to only certain sectors of activity, and the unified personal income tax (AmCham 1994).

Problems Related to the Export Sector: Difficulties in Exporting and Egyptian Trade Policies

Difficulties in exporting are regarded as only a moderate problem, because most firms in Egypt produce for the domestic market rather than foreign markets, and therefore they do not consider themselves seriously affected by export problems. The fact that the relative price of tradables to nontradables is shifting in favor of nontradables (see Table 4.8) could explain why many producers find it more profitable, and less risky, to sell in the domestic market rather than in the world market. This situation, however, is also consistent with the notion that an anti-export bias exists in the Egyptian economy, owing to indirect or so-called economywide effects of high average rates of protection for Egyptian manufacturing and other activities (DEPRA 1998b).

What Egyptian firms perceive more often, however, is that high average tariff rates, compounded by a cascading tariff structure, directly raise prices for many essential imported inputs and thereby limit these firms' potential for achieving greater international competitiveness and exports (Fawzy 1998).

With regard to Egyptian trade policies and practices, Egypt's average tariff rate declined only slightly, from 31% in 1988 to between 24% and 28% today. The maximum tariff rate on imports was reduced from 160% in 1989 to 80% in 1993 and to 55% today (except for maximum tariff rates on large cars, which were reduced in October 1996 from 160% to 135%). Nonetheless, the tariff structure of Egypt remains highly protective (by comparison to many other emerging-market countries). This encourages continued tariff-jumping FDI rather than more efficient, outward-oriented FDI. The Government has lagged in fulfilling its commitment to GATT/WTO to further reduce Egypt's maximum tariff level to 50% by 1995. In addition, the Government maintains an import service fee of 3% on imports with statutory tariff rates up to 30% and 6% on imports with statutory tariff rates exceeding 30%. Despite an agreement with the World Bank to reduce this import service fee by 1994, the Government has not done so (DEPRA 1997).

There also exists a sales tax of 5% to 25% on the landed value of imports. Import licensing has been abolished. To engage in foreign trade, exporters or importers must be authorized under the new Unified Investment Law, Law 8 of 1997. Also, imports of some final demand goods (i.e., goods for final consumption, not intermediate uses) can only by undertaken by Egyptian companies.

Finally, although trade policy is not usually considered among the characteristics of a liberal FDI regime in discussions of reforms to promote foreign direct investment in Egypt (and other MENA countries), the ability to

import and export freely is an essential requirement for effective participation in intra-firm trade of multinational enterprises in the new global economy. In this connection, although Egypt has made discernible progress in reducing its tariff rates in order to comply with international agreements, remaining rates of tariffs and non-tariff barriers still operate significantly to constrain potentially greater inflows of FDI to Egypt and potentially greater volumes of exports from Egypt (DEPRA 1997).

Public Sector and Government Size

Expansion of the private sector in Egypt is still limited by the prominence of state-owned enterprises, which are often the largest players, if not monopolists, in their sector (AmCham 1994). Currently, state-owned enterprises account for about 30% of GDP in Egypt, compared to an average of 11% in other developing economies. With regard to the government size, government expenditures in GDP have fallen since the advent of Egypt's privatization program, from 36% in 1993 to 28% in 1996. However, the 28% figure is still high, considering that, as reported by Fawzy (1998), government expenditures in GDP are appreciably lower in other prominent emerging-market countries: Chile and Indonesia (17%), Korea (25%), Mexico (23%), and Thailand (18%).

Egypt's investment laws contain a number of provisions relating to workers and their terms of employment. They provide that a percentage equal to not less than ten percent of a project's distributed profits must be distributed annually among project employees. (This reflects the requirement of Article 26, paragraph 1, of the Egyptian Constitution, which provides that "workers shall have a share in the management and profit of projects.") A similar provision obtains with regard to industrial investments under the Companies Law, Law 159 of 1981. Both the investment and companies laws incorporate certain provisions of Egypt's labor laws to the effect that individual investment projects must have 90 percent Egyptian workers, unless otherwise exempted. However, the investment laws relating to free trade zone projects require investment projects to have not less than 75 percent Egyptian workers. Egyptian minimum wage provisions are applicable to investments under both investment and companies laws, and all social benefits mandated in Egyptian law must be paid. The mandated or required social benefits constitute approximately 26 percent of wages paid (DEPRA 1997).

Global Integration of Egypt. For Egypt to achieve maximum potential from opening its economy to greater foreign trade and investment, the country must promote international integration of markets for both goods and services. It must also promote specialization of production whereby its factories become a part of global production sharing, typically through participating in foreign direct investment and outsourcing of intermediate goods by multinational enterprises. From this perspective, the role of FDI in promoting international integration is not limited to static effects. FDI may also make a dynamic contribution to economic performance, through promoting productivity,

economic efficiency, transferring technology, expanding industrial networks (both domestic and international), and exploiting international economies of scale. From either a static or dynamic perspective, FDI should be expected to lead to increased international competitiveness and hence expansion of manufactured exports.

Most of economic studies of FDI in Egypt have tackled issues related to FDI's most direct impacts, such as on the level of investment, exports, and employment. These studies find only a weak contribution of FDI to improvement in these economic variables (Mahboub 1998, INP 1996, Soliman, Abdel-Latif, et al 1996, FIAS 1991, Sakr 1989). For example, the INP study (1996) estimated that only 6.4% of textile and apparel production by MNEs located in FTZs in Egypt was exported. It also found that insufficient data precluded similar analyses for MNEs producing other manufactures.

Sakr (1989) showed that the contribution of MNEs to employment generation in Egypt has not exceeded 9% of the total labor force employed in manufacturing companies incorporated under Law 1974. He also inferred, if not formally concluded, that MNEs operating in Egypt preferred participating in import substitution industries and tended to use highly capital-intensive techniques. Another study (Abdel-Latif 1997) attributes this last finding to the rigidity of labor laws in Egypt, which tends to increase the effective cost of labor in manufacturing.

The contributions of FDI to technology transfer, economic efficiency, and global production sharing have not been analyzed, mainly because of insufficient and inadequate data. This suggests the importance of conducting questionnaires and field surveys to further analyze issues related to effects of FDI on the performance of the Egyptian economy. The only study found to directly deal with these issues focuses on transfer of technology (Sakr 1986). This study found that "the present system of technology transfer and diffusion (through FDI) contributes very little to the development of indigenous technological capabilities" (p. 44).[46] The study mainly attributes this result to four factors: (1) centralization of the decision-making by MNEs, (2) inadequate training and technical services provided by MNEs, (3) reluctance of MNEs to allow technological information outside the boundaries of subsidiaries; and (4) weak technological linkages to the rest of the economy, including to particularly scientific research institutions and the capital goods industry.

Regarding international integration, Abdel-Latif and Selim (1998) show that Egypt has been relatively slow to integrate with the world economy. This conclusion is attributed to several factors, but the most important factor is the low level of FDI inflows. From this study, it can be inferred that, to date, there has been no correlation between inflows of FDI and Egypt's growth of manufactured exports. Tables 4.9 and 4.10 show the status of international integration of the Egyptian economy, as measured by an index of integration developed by Abdel-Latif and Selim (1998).

[46] According to Haddad and Harrison, during the second half of the 1980s, presence of foreign firms in the domestic economy in Morocco did not accelerate productivity growth by local firms.

In contrast to the weak contribution of foreign direct investment to Egypt's export performance (INP 1996), foreign direct investment in Egypt is characterized by high import requirements, confronting the country with pressures on its balance of payments position.

MENA-Wide Comparative Perspective

Even though FDI has expanded dramatically during the last decade, countries in the MENA region appear to have been left out of this dramatic change in the world investment scene (Table 1.1).

Net FDI flows to MENA countries hovered around 0.5 percent of GNP during 1992-96 compared to about 1.5 percent for all developing countries. The MENA region had the lowest ratio of FDI flows to GNP of all regions of the world in 1996. Moreover, in contrast to the upward trend of FDI flows to most developing countries, FDI flows to MENA countries have remained constant or fallen as a percent of GNP during the 1990s. This reflects the general business and policy environment of the region, especially the slow pace of foreign investment liberalization, implementation of structural reforms, and removal of regulatory impediments, all of which have resulted in a generally less friendly climate for private sector investment in MENA compared to other developing regions.

However, there exists a wide dispersion among countries in MENA in regard to FDI trends and the climate for foreign direct investment. FDI flows to the region have been highly concentrated in four countries: Turkey, Egypt, Morocco and Tunisia. Together, these four countries account for about 74 percent of FDI flows to the region. Some other MENA countries such as Syria and Lebanon are beginning to attract appreciable FDI flows, but the magnitudes are still quite modest.

In North Africa, aside from Egypt, Tunisia is doing reasonable well, especially in terms of FDI per capita and in comparison to its population size. The situation in Morocco improved significantly in 1996, but the inflow of FDI per capita remains low at $14 compared to $41 per capita in Tunisia. When FDI relative to gross domestic product is considered, Egypt, Tunisia, and Morocco appear to be at the average level of all developing countries and close to the average level of other African countries. The shares of FDI in GDP in Egypt and Morocco are about 1.1 percent, while the share in Tunisia is 1.9 percent. These FDI shares in GDP, however, are still substantially below those of other emerging-market countries, especially prominent emerging-market countries in East Asia.

The stock of FDI is largest in Egypt, reaching $14.8 billion in 1996. In Tunisia and Morocco, stocks of FDI in 1996 were $4.5 billion and $3.4 billion, respectively. In per capita terms, the stock of FDI in Morocco is about four times lower than in Tunisia ($122 per capita versus $491 per capita, respectively). In Egypt, the stock of FDI in 1996 was about $250 per capita.

In the Middle East, only Turkey, followed by UAE and Syria, attract significant amounts of non-oil related foreign direct investment, with stocks of FDI estimated at about $1 billion in Turkey and between $120 million and $130 million in UAE and Syria (ERF 1998).

Many economic studies have been interested in accounting for these differences in foreign direct investment by studying the incentive structure for foreign investment in Egypt and other MENA countries compared to developing countries in other regions, especially Southeast Asia (Abdel-Latif 1998, Soliman and Abdel-Khalik 1998, ERF 1998, FIAS 1991 1998, Soliman and Abdel-Latif 1996). Many factors have been explored and analyzed, such as the tax and fiscal incentives system, approvals and administrative procedures, ownership structure and constraints, non-financial incentives, exchange rate regime, and economic risk and uncertainty. Studies by FIAS (1991, 1998) provide a detailed and informative comparison of incentive structures for foreign direct investment in Egypt, other MENA countries, and developing Asian countries.

The following are some of the major factors determining FDI flows in Egypt, Israel, Morocco, Tunisia, and Turkey (DEPRA 1997).

1. Political Stability

Tunisia is considered to have the best FDI record and prospects. It had an orderly, non-violent transition from the previous presidency, free from political violence and terrorism, with a highly popular president, and it has initiated steps toward a gradual transition to a higher level of democratic government. Egypt is viewed by foreign investors as a close second after Tunisia with similar political stability, affected only by occasional problems with extremist Islamic fundamentalists. Morocco is viewed as having a stable and popular government but with some uncertainty about eventual succession. Israel and Turkey both suffer from unstable, multi-party coalitions and from risks of terrorism and potential insecurity.

2. Business and Investment Policies

As yet, no MENA countries have moved far in establishing a free market economy, with open doors to foreign trade and investment. All have modestly lowered their trade barriers and corporate tax rates, abolished price and margin controls, and introduced incentives for foreign investment. However, liberalization of the economy remains substantially incomplete, with the least progress achieved with regard to privatization, deregulation, and bureaucratic reform. In these areas, Egypt has the poorest record. It has begun to privatize the economy, yet customs administration continues to be arbitrary and highly discriminatory in its practices, with no effective recourse to the court system. Morocco has already greatly simplified its customs procedures, Tunisia has set up an efficient one-stop-shop system of investment and license approval for foreign investors, which could serve as a model for developing countries worldwide, and Turkey has increasingly freed its business sector from bureaucratic controls in order to become eligible for accession to the European Union.

3. National Treatment

Israel provides the most extensive non-discriminatory treatment of foreign investors among the five MENA countries. Morocco also has a good record, but foreign investors are not permitted to own agricultural land, and government procurement procedures are at times skewed toward nationals in an arbitrary, non-transparent manner. Turkey generally does not discriminate against foreign investors, but foreign mining companies have encountered delays in obtaining the necessary permits to start operations. Tunisia requires prior authorization for inward-oriented investments involving majority foreign equity participation. Such investments also require prior authorization to remit profits abroad. Reportedly, MNEs must also document why inputs must be imported from abroad rather than sourced domestically in order to qualify for foreign exchange from the Central Bank to pay for imported inputs. Egypt discriminates against foreign investors in a number of ways. For example, Egypt bars foreign firms from investment and commerce, and most import activities, in strategic sectors. Also, Egyptian-owned companies are given a 15% price preference in public tender bids over foreign-owned companies. Finally, the scope for foreign participation in Egypt's privatization program is limited by sale of equities through the local stock exchange on a preferential basis to employees and domestic investors first, followed by Arab investors, and only thereafter by other foreign investors. The Companies Law requires an initial 49% share offering to Egyptians and that a majority of the Board of Directors must be Egyptian nationals (DEPRA 1997).

4. Profit and Capital Remittance

In Turkey, foreign investors can freely remit their profits abroad without prior authorization. In Morocco, foreign investors can freely remit profits and repatriate capital, provided the initial foreign investment is registered with the Exchange Control Office. Israel permits authorized banks to make foreign exchange available to companies for profit remittances, provided the original investment is made through an authorized bank. In Tunisia, freedom to remit profits and repatriate capital is limited to companies with at least 66% foreign equity ownership; other companies require prior government authorization. In Egypt, no limitations apply to profit remittances or repatriation of invested capital, whereas, in the past, foreign capital invested in Egypt could be repatriated only up to the amount of the foreign investor's balances in commercial banks and by applying the foreign exchange rate prevailing when the investment was originally made.

5. Exchange Rate Stability

Since 1990, Egypt's record of exchange rate stability is matched in the MENA region only by Morocco and Tunisia. However, the exchange rates of all three countries are now widely considered overvalued, imposing a growing handicap on international competitiveness. Both Turkey and Israel have suffered recurring bouts of exchange rate instability, related to the difficulties of controlling their high rates of inflation.

6. Trade Liberalization
Tunisia and Morocco have dismantled major nontariff barriers to imports, reduced tariff rates, and simplified customs procedures. However, high levels of protection for agriculture prevail. Turkey has lowered tariff duties and made import licensing increasingly automatic. Israel maintains the most extensive nontariff barriers, including outright import prohibitions, and employs decreed values for imports, a practice that usually artificially inflates landed prices of imports for custom duty valuation and thus protects domestic producers. Egypt has reduced the average level of its tariffs, but tariff rates remain high for selected products in order to protect favored domestic sectors from import competition.

7. Market Size and Growth
Turkey has the largest market among the five MENA countries and probably the greatest growth potential (WEF 1997). Israel also represents a large market owing to the high purchasing power of its population and the country's robust export growth. But the country's prospects for long-term growth may be limited. Egypt has a large potential market owing to its very large population but its market continues to be limited by low purchasing power and economic policies constraining private investment, and growth and diversification of exports.

8. Investment Incentives
Israel offers the most generous incentives to foreign direct investment, including a government grant of up to 35% of the value of the initial investment to "approved enterprises." Tunisia offers a 10-year corporate tax exemption and other fiscal incentives to companies that export at least 80% of their production. Other new investments receive a tax exemption on reinvested profits of up to 35% of taxable income, plus other incentives. Morocco offers a 5-year corporate tax exemption to exporting MNEs or foreign firms willing to locate in economically depressed areas. Turkey offers new foreign investors guarantees of national treatment, access to all industrial sectors, up to 100% foreign equity ownership, and freedom to remit profits. Egypt offers qualifying foreign investors a 5-year corporate tax holiday that may be extended for another five years under most circumstances, and other minor incentives.

9. Taxation
Tunisia has the lowest and Israel has the highest maximum corporate tax rate in MENA. At 40%, Egypt has a corporate tax rate near the high side of this tax range (DEPRA 1997).

10. Bureaucracy
Investors are generally pleased in their dealings with high-level officials in Egypt but become frustrated in contacts with low level bureaucrats who control the multiplicity of permits and licenses needed to establish and operate investment projects. Egypt compares unfavorably with countries such as Turkey and Indonesia where high level officials are frequently willing and able to overcome

bureaucratic hurdles, and Tunisia where fewer bureaucratic problems are typically encountered. Although investors report that corruption in Egypt is less frequent than in other developing countries, they complain widely about the unwillingness of government bureaucrats to make decisions.

In Tunisia, significant gains have been made by the government to simplify approval procedures and regulatory controls on foreign direct investment. Nonetheless, the approval and regulatory climate for foreign direct investment is still regarded as complex and bureaucratic by most MNEs, especially those with no prior experience in Tunisia. The negative perception of foreign investors stems largely from rigid exchange controls, complex procedures for investment approval in certain sectors, and denial of some incentives to wholly owned subsidiaries of multinational enterprises. MNEs are frequently compelled to establish partnerships with local producers in order to undertake investments (FIAS 1991).

Table 4.12 provides summary of investment laws and incentives in the five emerging-market MENA countries reviewed here, along with developing countries in other regions. Following a recent Ministry of Economy study on Egypt's international competitiveness (DEPRA 1998b), the summary differentiates between financial incentives related to the tax system and investment allowances, on the one hand, and non-financial incentives related to marketing (domestic and internationally), training, and R&D development, on the other hand.

Overall Ranking. Simple ranking of the above ten issues shaping the climate for foreign direct investment in MENA places Morocco and Tunisia in the highest position and Egypt in the lowest position for attracting long-term foreign investment. More complex ranking of the ten issues, based on weighting the relative importance of each of the ten issues to foreign investors, places Turkey in first place, followed by Morocco, and then Israel. Egypt again places last. Egypt scores poorly in all ten categories of concern to foreign investors, except exchange rate stability and political stability (DEPRA 1997).

An additional factor that is important in explaining FDI flows to MENA countries is differences in quality and capability of factors of production in these countries (ERF 1998; Abdel-Latif 1998). Differences in such elements as education levels, labor force skills, and saving rates are studied under this heading.

A novel feature of the ERF (1998) study is its attempt to order the importance of several factors affecting FDI inflows. The study grouped the ten factors above into five sets of indicators forming what the study terms the "pyramid" of FDI behavior: ***societal attractiveness*** which includes the country's openness and its general attitude toward foreigners and foreign-owned property; ***infra-structural attractiveness*** which includes the quality and coverage of infrastructure, property rights and their legal protection, and the stock of existing FDI; ***factor attractiveness*** which includes the availability and quality of human resources, capital resources, and raw materials; ***governable attractiveness*** or the general ability of governing elites to achieve consensus within the rule of law; and,

finally, ***competitive attractiveness*** or the importance of the country's situation, capabilities, or policies that are consistent with or directly support the strategic objectives of MNEs.

These five indicators are conceived of as a hierarchy, or pyramid, in which the highest level indicator (competitive attractiveness) does not influence MNE decisions to invest in a particular country until lower level indicators reach acceptable levels in the country concerned.

Turkey, Tunisia, Morocco, Oman, UAE, and Egypt have reasonably good societal attractiveness. Most other MENA countries exhibit a negative attitude towards foreigners in general and towards foreign direct investment in particular.

Most countries in the MENA region do well on technical infrastructure, such as provision of electricity and telecommunications. But foreign investors widely believe that MENA countries neglect managerial aspects of public policies and services. This is one of the main factors limiting long-term foreign investment in Egypt and Morocco. Improvements are underway, however. Both countries are working on reforming bureaucracy. And, in Egypt, new build-operate-transfer (BOT) arrangements are being developed to improve the provision and reliability of public roads, railways, and port facilities, through involvement of the private sector.

Most MENA countries fare well with regard to the availability of raw materials and energy resources. However, they fare only average for human resources, and they appreciably lag behind in technology. Levels of education, for example, are relatively high, but application of knowledge is more limited. Moreover, especially in Egypt where widespread higher education has been achieved at the cost of quality, the general proficiency of educated workers and professionals is perceived to be of low-to-medium quality by a number of observers if not also many potential foreign investors (Shafik 1996; Birdsall and O'Connell 1999).

Governance is seen as a major problem in some MENA countries. The legitimacy of several governments is strongly questioned. Most have successfully conducted economic restructuring programs, significantly liberalized their FDI rules and procedures, and provided generous incentives to potential investors. But with the exception of better performing countries such as Turkey, most foreign and domestic investors have flocked to situations in which they might take advantage of sheltered markets.

With reference to the pyramid concept developed by the ERF study (1998), MENA countries appear to concentrate efforts on getting higher level factors right (for example, competitiveness). But these efforts are undermined by problems at lower levels of the pyramid, such as problems with education and technical knowhow in Egypt, and much more serious problems at lower levels of the pyramid in other MENA countries such as Algeria, Iraq, and Syria.

Other studies that rank MENA countries in terms of their attractiveness for foreign direct investment find that Egypt lags appreciably behind Turkey, Tunisia, and Morocco. This conclusion coincides to a great extent with the finding of World Economic Forum *Global Competitiveness Report* (WEF 1997), which assesses future prospects of individual countries for attracting foreign direct investment.

Another recent comparison of conditions in MENA for foreign direct investment is presented by El Erian and El Gamal (1997). The two authors develop and apply an analytical framework to assess policies towards FDI in Arab countries, with emphasis not only on incentives to attract those FDI inflows but also on factors guaranteeing benefits from FDI for host countries. Among the primary incentives for attracting beneficial FDI, El Erian and El Gamal include:

--Policies that foster macro economic stability and predictability,

--A high degree of openness in the economy,

--A tax structure that encourages equity and direct investment financing, and does not give excessive benefits to debt financing, and

--Public and private investment in infrastructure and social sectors (health and education, in particular, because such investment improves the productivity of labor in a sustainable fashion).

Among the primary incentives for attracting inappropriate FDI, they include:

--Preferential exemptions from trade barriers, and

--Preferential exemptions from tax liabilities.

Where FDI is attracted by "bad" incentives, the outcome in host countries is typically: (1) failure of infant industry strategies to "grow" internationally competitive firms and industries; (2) increased domestic consumption, and a reduction in domestic saving and investment; (3) deterioration in the balance of trade owing to increased imports of intermediate goods; and (4) potential net capital outflows owing to profit repatriation by MNE subsidiaries in excess of foreign exchange earnings. All these results are harmful to the development objectives of the host country. For example, the net effect of domestic tax exemptions for MNEs is equivocal. On the one hand, it provides an incentive for FDI to flow into the host economy. On the other hand, since these tax exemptions tend to be extended for periods of about five years, types of FDI attracted by these incentives are likely to be relatively short-lived in the host country.

El Erian and El Gamal also observe that although Arab countries are relatively generous in offering incentives for foreign investment, they have mainly failed to attract sustained, large inflows of FDI. In part, this is explained by failure of Arab countries to maintain appropriate "enabling" environments for investment and saving. Fortunately,

this situation is changing, with a number of Arab countries stepping up economic adjustment and reform measures.

Tunisia stands out as the MENA country most successful in attracting relatively large FDI inflows on a consistent basis during 1980-1996. This is consistent with previously discussed assessments of Tunisia as a country that has implemented mostly prudent economic policies.

Compared with the past, Egypt today offers a much better foreign investment environment. However, compared with other countries in the region and around the world that have aggressively instituted reforms and incentives to attract foreign direct investment during the last decade, Egypt is falling behind. The gap shows in FDI statistics and, more importantly, in expressed opinions of many official of firms conducting business worldwide.

Unfortunately, Egypt still finds itself in the midst of a transition from a centrally planned economy to a system based on free markets and private enterprise. Egypt's policy makers have not yet fully abandoned their past economic orientation. Specifically, it appears that they are not convinced a free market economy is in the best interest of Egypt. But, not to move forward to embrace free markets and private enterprise risks "marginalizing" Egypt in the new global economy. That is, it risks Egypt losing out in the global competition for world export markets, and essential foreign capital and technical knowhow, to developing countries in other regions that are advancing more rapidly with trade and investment liberalization, and with perfecting their competitive free market economies.

In short, FDI should be analyzed as a process that is determined by a number of factors, including fundamental economic factors, such as market size and potential growth, availability and adequacy of financial, human, and natural resources, and availability and adequacy of transportation and communications infrastructure. However, a second important group of factors are institutional factors that shape, in one way or another, the business and policy environment for foreign direct investment and its onward effects on exports and employment, technology transfer, and economic growth. These institutional factors include macroeconomic stability and openness of foreign trade and investment policies, transparency of the legal and regulatory system, degree of bureaucracy and corruption, efficiency of the judicial system, and governance.

Egypt enjoys a relatively large market within the MENA region as well as an abundance of low-wage semi-skilled labor. The country is also on its way to providing adequate infrastructure to attract greater foreign direct investment. However, Egypt is especially deficient relative to emerging-market countries in MENA and other regions in providing an appropriate environment for attracting greater foreign direct investment, owing to the number of institutional factors which are reviewed here and partially summarized in Table 4.13, that need to be remedied.

Latin America

Before the emergence of Southeast Asian countries as economic powerhouses, the Latin American region was the principal recipient of FDI in the developing world. In 1980, FDI stock in Latin America amounted to $48 billion, which represented 44% of all FDI stock in developing countries, surpassing Southeast Asia (29%) and Africa (20%). The sectors that MNEs were most interested in were natural resources and inward-oriented manufacturing. The regime under which they operated was very restricted: ownership ceilings, restrictions on profit remittances, complex registration and administrative procedures, economic sectors that were off limits -- utilities, telecommunications, hydrocarbons, the media, etc. -- and restrictions on hiring and firing of workers and managers.

The economic policy regime was characterized by the unrelenting pursuit of import substitution industrialization (ISI) in large and small countries alike. By the late 1970s and early 1980s, however, this strategy had reached a dead-end in most of the countries of the region. Once countries moved beyond the “easy” phase of import substitution for consumer goods, import substitution for intermediate and capital goods required ever larger domestic markets for the achievement of a minimum efficient scale of production. This was not possible in small and medium-sized economies, or even in the larger countries such as Brazil and Mexico which are seriously handicapped by uneven distribution of incomes and large pools of unemployed and underemployed workers. The capital intensity and import content of investment projects rose, but the problem of domestic products of high prices and inferior quality and, consequently, of poor competitive performance in world markets was not solved. If anything ISI, by penalizing the development of exports in general, intensified the foreign exchange constraint.

Subsidiaries of manufacturing-based MNEs operated in this context. Until the early 1980s, the combination of high protection on final goods, an almost zero tariff on intermediate inputs, an overvalued exchange rate, and preferential access to subsidized credit from domestic financial entities did make their operations profitable *in local currency*. But the situation drastically changed with the onset of the debt crisis in 1982. Severe economic contraction followed and, with this, lower real incomes and declining levels of private and public consumption. The subsidiaries of MNEs thus had to contend with shrinking domestic markets. In addition, successive exchange rate devaluations and the fact that the countries had to assign foreign exchange to service the debt put an end to the easy and cheap ways of buying intermediate inputs. All this meant a declining profitability in this traditional modality of MNE operation in Latin America that was ultimately reflected in a lower share of FDI stock among developing regions. In effect, by 1990, Latin America’s share had been reduced to 34% and that of Southeast Asia had risen to 44%.

Since the 1980s however, there has been a revival of FDI in Latin America which has followed the implementation of effective macroeconomic stabilization and the adoption of open trade policies and liberal foreign investment regimes. The recent

experiences of five countries -- Argentina, Chile, Mexico, Peru, and Venezuela -- are summarized in Table 4.14.

Argentina

Since the 1970s, Argentina has led other Latin American countries in adopting an economic regime friendly to foreign investors. For example, it allowed for unlimited dividend remittances and unrestricted capital repatriation, and it guaranteed equal treatment for foreign firms. FDI restrictions were confined basically to administrative matters, especially the requirements of prior authorizations for investments projects in energy, media, information, and telecommunications sectors (Agosin, 1996). However, until 1990, FDI was spotty at best. Annual net flows averaged $456 million during 1980-84 and declined to $187 million during 1985-89, which represented respectively 6% and 4% of gross capital formation. This dismal performance is explained by the severe foreign debt crisis and a macroeconomic context permeated by runaway inflation.

As Table 4.1 shows, a spectacular turnaround occurred during the 1990s. Annual FDI inflows average $3,856 million. Argentina has certainly become a magnet for FDI. The principal reasons are the following:

- A successful stabilization of the economy that brought inflation down to single digit levels in just two years. The anchor of the strategy was the adoption of a currency board that pegged the domestic currency to the dollar and that legally prohibited the central bank from buying public and private sector financial instruments. Money supply was thus limited to the volume of dollar reserves.

- Far reaching structural reforms that included more open trade and financial regimes, market deregulation, and privatization of state-owned enterprises (SOEs).

- Trade integration with Brazil, Uruguay, and Paraguay (Mercosur).

- Further liberalization of the FDI regime. Requirements for prior authorizations for investments in the energy, telecommunications, insurance, information and electronics sectors were eliminated by 1993. As of today, this requirement only applies to sectors associated with national defense.

Two waves of FDI inflows have characterized the 1990s. From 1990 to 1993, FDI was spearheaded by the privatization of SOEs. In this period, 54% of total FDI inflows was accounted by privatization of state concerns in the energy, transport, and telecommunications sectors. In order to further this process, the government allowed foreign investors to use external debt notes, usually bought with hefty discounts in secondary financial markets, as a means of payment. This period also witnessed inflows from manufacturing-based MNEs that benefited from the recovery of internal demand. At the same time, and given the context of a freer trade regime, these entities faced more

stern competition from foreign concerns. In order to expand or protect their domestic market shares, they started a process of modernization of their facilities. In all, as a percentage of gross capital formation, FDI inflows rose to 11% during this period.

The second wave, from 1994 through 1997, is characterized by the acquisition of existing domestic firms and, to a lesser extent, by greenfield investments. During 1995-97, the former represented 41% of total FDI inflows, while greenfield investments accounted for 33%. As a consequence, MNEs have come to play an increasingly important role in the Argentine economy. Among the 500 largest enterprises that operate in the country, MNEs increased their share of total sales from 34% in 1990 to 51% in 1995. In that year, their weight seemed to be particularly relevant in foodstuffs, beverages, and tobacco (51%); paper (62%); chemicals and petrochemicals (82%); cosmetics (91%); rubber (78%), electronics (76%), and automobiles and auto parts (45%). Furthermore, and unlike the experience during the first wave of the decade, MNEs have come to play a critical role in the expansion of the country's exports.[47] Increasingly, Argentine exports are becoming more dependent on the Mercosur market, and as much as 50% of total exports to this market are accounted by sales from MNEs which have posted a superior performance to that of domestic firms. In fact, while sales to Mercosur from the latter rose by 78% in 1993-96, those of MNEs increased by 149% in the same period (CEPAL, 1998).

The signs, then, are unequivocal. Since 1990, FDI has played an increasing role in gross capital formation, has introduced new technologies that have led to increases in total factor productivity, and has helped to expand exports. Still, there remains the question however of whether the pace of outward-oriented manufacturing can be sustained. The jury, in this regard, is still out. For one, manufacturing exports have yet to pass the international test of competitiveness *outside the Mercosur market*. And, on the other hand, trends suggest that the manufacturing sector is seeing declining shares of FDI stock. In effect, by 1992, the share of FDI stock in chemicals, transport equipment, and other manufacturing had declined to 53% from 62% in 1980 (Table 4.15). This trend is more pronounced when considering recent inflows: in 1992-96, while 30% of total inflows was accounted for by capital-intensive manufacturing projects, 55% was absorbed by services – finance, utilities, commerce, and communications. The rest (15%) was constituted by investments in petroleum, natural gas and mining. More FDI in these natural resource sub-sectors are expected in years to come, as the country seizes its comparative advantage to become a major exporter of energy to neighboring countries. In all, the trend indicates that while MNEs still view Argentina's competitiveness as a function of the strength of its domestic market and access to a larger regional bloc, they are becoming increasingly more interested in exploiting its rich natural resources (CEPAL, 1998).

[47] In 1993-96, while total exports increased by 80%, MNEs exports rose by 109%.

Chile

Like Argentina, this country introduced a more open FDI investment regime and free trade and financial market reforms in 1974-75. During the period 1975-85, annual FDI inflows averaged $200 million, or approximately 6% of average annual exports. But from 1986 onwards, FDIs inflows skyrocketed. The average annual inflows rose to $530 million during the remainder of that decade. In the first five years of the 1990s, the average increased to $1.7 billion, and to $5.0 billion during 1996-97, that is, 30% of annual exports.

In just twelve years then, FDI inflows to Chile increased by a factor of 25. This, indeed, is a most impressive performance. The principal factors that explain this are the following:

- Macroeconomic and political stability. At present, Chile offers one of the best country-risk ratings among developing countries. This is reflected by the fact that the country attracts MNEs from a variety of geographical sources.[48]

- Predictable "rules of the game" for FDI. It is telling that Chile does not feature the most open FDI regime of the region.[49] Yet, MNEs are clearly satisfied with the legal and institutional stability that the country offers.

- Successful implementation of a debt-equity conversion program.

- A competitive real exchange rate.

Unlike Argentina, privatization did not play a major role in generating FDI inflows. Rather, the debt equity conversion program proved to be the decisive catalyst.[50] During 1987-90, this instrument accounted for 78% of total inflows. From then on, debt equity conversions petered out as the price of Chilean notes in secondary financial markets approached par value, but regular FDI did not slacken. To the contrary, inflows increased substantially. By 1995, they constituted 12% of gross capital formation and as a percentage of gross domestic product they had increased to 5%, significantly higher than the 1% posted in 1985.

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[48] Statistics compiled by CEPAL (1998) indicate that, in 1997, the principal sources of FDI inflows were the United States (18%), Canada (13%), Spain (31%), South Africa (9%), Netherlands (7%), and other countries in the European Union (6%). With respect to FDI stock, according to IRELA (1996), by 1995 the United States was the principal source (41%), followed by Canada (18%), Spain (5%), United Kingdom (5%) and other countries of the European Union (10%).

[49] For example, foreign investors are required to present detailed statement of capabilities, authorization is not automatic, and capital cannot be repatriated before a certain timeframe (Agosin 1996). In addition, foreign investors operate in a context characterized by strict capital controls.

[50] These were effected under the so-called Chapter XIX. The mechanism was simple: a foreign investor would buy Chilean debt notes in secondary financial markets at a hefty discount and exchange them for peso-denominated certificates at close to par value. The Central Bank would honor the certificates provided the investor demonstrated that the proceeds would be used to finance *new* investments. This mechanism had the additional advantage of reducing the stock of foreign debt.

Given the presence of a competitive exchange rate, it is not surprising that 75% of FDI inflows during the period 1974-96 have been devoted to expanding the production of tradable goods. In this regard, the impact on export growth has been formidable. During the period 1990-95, while the country's exports grew at an annual rate of 11%, foreign sales of MNEs did so at a rate of 19% (CEPAL 1998). In all, it is estimated that 40% of total exports are accounted for by foreign sales of MNEs. It must be noted that MNEs still view Chile's comparative advantage as consisting primarily of natural resources and less as a source for the production of outward-oriented manufactured goods of high domestic value added (Table 4.16). As such, at least 50% of total FDI inflows during 1974-1996 went to developing large mining projects. But the entities have contributed significantly to export diversification, as natural resource-based manufacturing goods, such as paper and agro-industrial products, make sustained inroads in world markets.[51] The challenge for the country now is to widen the array of manufacturing exports and, ultimately, to make a successful transition towards developing a more capital and knowledge-intensive export economy.

Mexico

Until the mid 1980s, Mexico featured one of the most restrictive FDI regimes in the entire region. There were strict ownership restrictions, numerous sectors of the economy that were off limits to foreign investors, smothering administrative requirements, and the like. The only modality of FDI that did materialize was that of inward-oriented industry. There was one exception: the maquiladora operations, which were essentially labor-intensive assembling plants established in townships near the border with the United States that catered production exclusively for export to the US market. A special regime — including the application of liberal labor laws, duty free import of intermediate inputs, and tax exemptions — ruled these operations.

As occurred in the other countries of the region, the debt crisis and the costs associated with industrial protection prompted the economic authorities to adopt more open trade and financial policies, and a more liberal FDI regime. The measures have helped transform Mexico into the major recipient of FDI in the region. While during the 1980s FDI inflows averaged annually $2.4 billion, the figure had increased to $4.0 billion during 1990-93 and to $10.5 billion during 1994-97. The FDI process has not been spearheaded by privatization of SOEs like in Argentina, nor by debt equity conversions like in Chile. Rather, the main modality has been greenfield investments and also the acquisition of existing domestic firms by foreign investors. This latter modality became more prevalent after 1994, in the aftermath of the devaluation of the peso, and it is gradually becoming more important. In point of fact, approximately 60% of total inflows in 1997 was accounted for by purchases of existing assets in the sectors of telecommunications, beverages, commerce, and banking and insurance. The bulk of these acquisitions derives from US-based foreign investors (CEPAL 1998).

[51] In 1974 80% of exports was accounted for by copper and the rest by a handful of agricultural goods. In 1998 exports were five times as high, and copper represented only 35% of the total.

Unlike the period of ISI, FDI inflows are now export-potential driven and concentrated predominantly in manufacturing (Table 4.17). Plentiful supply of labor and a competitive exchange rate since 1994 are boosters of this process. At present, total country exports amount to $120 billion, a six-fold increase with respect to 1988, of which 60% corresponds to foreign sales of MNEs (CEPAL 1998). This percentage is steadily rising. In general, MNE investment activity has been greatly stimulated by the North American Free Trade Agreement (NAFTA). MNEs see Mexico as a strategic export platform for manufacturing products such as textiles, electronics, automobiles, auto parts, and information that are primarily placed in the United States but gradually in other markets as well. Not surprisingly, the bulk of the FDI stock (60%) derives from US-based MNEs.

What is evolving then is the extension of the maquila-type of operations to the rest of the country. As long as Mexican real wages remain substantially below the levels of the United States, MNEs will concentrate in the expansion of maquilas and less in orienting output towards the domestic market. The latter is bound to expand, however, as local firms increasingly become more articulated with MNEs and thus acquire the technical skills for the efficient production, at lower prices, of import substitutes. Consequently, stronger linkages with the Mexican economy – beyond the mere utilization of "cheap labor" – are expected from FDI in the long run.

Peru and Venezuela

Peru features the most liberal FDI regime in the region. It was enacted in 1992. It allows for FDI in all sectors of the economy, 100% foreign ownership across the board, neither limits nor prior authorization to the remittances of profits and capital, free access to the foreign exchange market, and tax stability. The design of this regime followed the worst performance of the Peruvian economy of the century. During the 1980s, annual inflows averaged just $3.0 million, a poor show largely attributed to gross economic mismanagement, over-indebtedness, social and political unrest, and natural disasters.

Other than the present FDI regime, the higher inflows of FDI observed in the 1990s is largely a result of far reaching economic structural reforms and a very successful privatization strategy. In fact, 82% of total inflows during the decade are explained by the sell off of SOEs. It is worth noting that these transactions have not been merely an exchange of assets. To the contrary, the new foreign owners have invested in the modernization of the acquired firms, as mandated by the terms of asset transfer. Not surprisingly then, as a percentage of gross capital formation, FDI inflows in Peru rose from 0.89% in 1990 to 21.4% in 1994, and as a percentage of gross domestic product from 0.14% to 4.71% during the same period.

On the other hand, FDI has been largely confined to big mining projects and, most notably, to asset acquisition in the services sector, such as transport, commerce, banking, and telecommunications (Table 4.18). The country, so far, has been incapable of attracting FDI for outward-oriented manufacturing. The tendency for exchange rate

overvaluation, rigidity in labor markets, and poor quality of economic infrastructure are in part to blame.

Venezuela, which since 1990 also features an open FDI regime, has reversed the sluggish performance observed during the 1980s. During the 1980s, annual FDI inflows averaged just $10 million. During the following decade they jumped to $1.5 billion. This impressive recovery was led first by the application of a debt equity conversion program and later by the successful privatization of SOEs in the telecommunications, transport and petroleum sectors. Overall however, FDI inflows in the 1990s have been erratic, mainly because of political unrest during 1992-95, a banking collapse in 1994, and a severe economic crisis that has shaken the confidence of domestic and foreign investors alike.

Venezuela is extremely rich in natural resources, especially in oil and mining. Oil is the most important industry. It constitutes 25% of gross domestic product, 50% of total fiscal revenues, and 80% of total exports. The entire industry was taken over by the state in 1976 and, as such, it was barred from participation by foreign investors. Ambitious plans to expand production were stopped in the mid-1980s when the Venezuelan state was cash strapped. Since then, conditions have not improved, as oil prices have not regained the levels observed during the 1970s. For these reasons, the industry was reopened to foreign investors in 1995. Under this new regime, foreign-owned firms can sign agreements with the state-owned company (PDVSA) to manage production in existing wells and to explore new oil fields. The policy has been a success. In 1996 eight oil fields were transferred to thirteen foreign companies, and, a year later, these companies were given the concession of seventeen fields (CEPAL 1998). The geographical source of these investments is varied.[52]

At the same time, oil has been the curse of the Venezuelan economy. In fact, the country has historically featured the worst symptoms of "Dutch disease." The inability of successive governments to deal with this problem effectively has seriously affected the international competitiveness of agriculture and industry. The latter, including machinery, chemicals and plastics, and foodstuffs and beverages, did develop during previous decades and successfully attracted FDI (Table 4.19). However, these industrial sectors were over protected. As recent trends indicate, FDI is gradually steering away from this type of manufacturing[53] and, as noted above, is more focusing on oil exploitation and mining projects, and manufacturing of petroleum products. Finally, service sectors are

[52] Among the companies that won concessions are United States' ARCO, Phillips Petroleum, Union Texas, Mobil and Amoco; Canada's Pan Canadian Petroleum Limited; Argentina's Pérez Companc; United Kingdom's British Petroleum; Germany's Veba Oel AG; Japan's Nippon Oil; and France's Elf Aquitaine (CEPAL 1998).

[53] The exception is automobile assembling. The low cost of gasoline and the high domestic demand for motor vehicles has enticed auto companies to expand production. In 1998 there were eight companies with assembling operations -- United States' General Motors, Ford, Chrysler and Mack; Italy's Fiat; Japan's Mitisubishi and Toyota; and Korea's Hyundai. The bulk of production is sold locally, but in the last two years there has been observed increasing foreign sales to Colombia and Ecuador (CEPAL 1998).

also attracting FDI. The two service sectors that stand out are telecommunications, recipient of $1 billion worth of inflows in 1997, and banking.[54]

Asia

Developing Asian countries form a particularly large and diverse group of advanced and less developed countries. Together, they account for about 15 percent of world land area but over half (53 percent) of world population, making developing Asia the most populous region of the world.[55]

The economic success of developing Asian countries, termed the East Asian Miracle by the World Bank (1993), has been widely attributed to the openness of the region towards foreign trade if not also foreign investment. Under sustained liberalization of import barriers, adoption of pro-export policies, and relatively stable, non-inflationary monetary and fiscal policies, particularly the newly industrialized countries (NICs) of East Asia – Hong Kong, Korea, Singapore, and Taiwan – and major market-oriented countries of Southeast Asia – Indonesia, Malaysia, Philippines, and Thailand (the so-called ASEAN-4) – have been widely credited with allowing domestic (relative) prices for traded goods and services to approximate those prevailing in international markets dominated by more advanced countries. As a result, these Asian countries have successfully integrated their economies with the economies of the major industrial countries and the world at large, giving rise to robust export and macroeconomic growth. Moreover, this strategy has come to be adopted increasingly by other emerging-market countries, including in South Asia (which is chiefly composed of Bangladesh, India, Pakistan, and Sri Lanka) where highly distorted economic incentives associated with import substitution policies to promote rapid industrialization prevailed until recent years.

The remarkable economic performance of East Asian countries has also been supported by “dynamic” factors, particularly, foreign technology, increasing labor skills, and managerial knowhow acquired by East Asian NICs (mainly Hong Kong and Singapore) and, more recently, by China and the ASEAN-4 through foreign direct investment by multinational enterprises. During 1985-95, foreign direct investment in the East Asian countries ($50 billion in 1995) – chiefly, China ($34 billion), Malaysia ($4 billion), Indonesia ($4 billion), and Singapore ($4 billion) – came to represent a dominant share of (net) foreign direct investment flows to developing countries ($101 billion in 1995). Foreign direct investment in South Asia during this period was negligible by comparison, amounting to just $3 billion in 1995.

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[54] Foreign financial concerns now hold 60% of assets of the banking system. In the main, this reflects not new investments but an asset sale from the state, which had taken over the collapsed banks in 1994, to foreign firms.

[55] For the analytical purposes here, the developing Asian countries are differentiated according to their location in East Asia or South Asia. East Asia consists of China; four high-income "newly industrializing economies" (NIEs) – Korea, Hong Kong, Singapore, and Taipei, China; and several low-income and middle-income economies in Southeast Asia – Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Thailand, and Vietnam. South Asia consists of seven predominantly low-income countries: Bangladesh, Bhutan, India, the Maldives, Nepal, Pakistan, and Sri Lanka.

The Asian currency crisis began with the floating of the Thai baht in mid-1997. Today, downward pressure on exchange values of currencies continues in not only Asia but also other regions that are host to emerging-market countries. The Asian crisis has revealed critical weaknesses in the institutional fabric of many countries in developing Asia with heretofore exceptional records of high growth, strong export performance, and stable macroeconomic economies. Inadequate regulatory and prudential controls on banking and financial intermediation, it is argued, has allowed domestic lenders and borrowers in these countries to use short-term international funds to engage in ill-advised long-term investments without concern for fully bearing the risks of the (unrealizable) expectations vested in highly leveraged commercial and industrial projects (Krugman 1998).

Notwithstanding the Asian currency crisis and important issues raised by contrarians in objection to uncritical views of the East Asian Miracle,[56] the remarkable growth and export performance of the developing Asian countries continues to stand as a testament to the potential of open economic policies. Indeed, despite the Asian crisis, developing Asian countries continue to attract substantial inflows of foreign direct investment.

The remainder of this subsection considers the experience with foreign direct investment of two Asian countries particularly similar to Egypt: Indonesia and Pakistan. Like Egypt, these two countries are populous, low-to-middle-income countries. Other similarities of the two countries to Egypt are also important to note. Indonesia is importantly endowed with energy resources, and both Indonesia and Pakistan have large agricultural and rural populations. Finally and arguably most important, like Egypt, the two developing Asian countries highlighted here have long histories of statism and extensive controls on trade and foreign direct investment.

[56] See Krugman (1994) and Young (1994, 1995).

Indonesia[57]

Foreign direct investment in Indonesia did not climb to the heights of foreign investment flows to more advanced developing countries in East and Southeast Asia until the early-to-mid 1990s (Table 1.1). This development corresponds to the gradual lifting of tariff and especially nontariff restrictions on imports that began during the preceding decade. However, it corresponds more discernibly to a series of bold foreign investment liberalization measures undertaken by the government in 1992, culminating in a major deregulation package in 1994 that removed most restrictions on investment and other activities by multinational enterprises.

Before 1992, Indonesia's policies towards foreign trade and investment underwent a number of cycles driven mainly by the availability of capital, which initially was linked closely to the country's oil revenues. With Indonesia's independence in the 1960s, many enterprises were nationalized. However, during the late 1960s the government adopted the "open door" policy, returning nationalized enterprises to their previous owners and passing a FDI law that provided guarantees again expropriation and incentives in the form of reduced import taxes and income tax holidays. In addition, 100 percent foreign ownership was allowed and most sectors were opened to foreign companies. However, under continued nationalism, it was envisioned that foreign participation in the Indonesian economy would be phased out over a 30-year horizon.

This horizon was shortened dramatically during the ensuing decade. In 1974, the government prohibited 100 percent foreign ownership, increased the number of industrial and other sectors closed to foreign investment, and required presidential approval for all foreign direct investment under the administration of a newly created board of investments.

There followed a period of gradual liberalization, but significant liberalization did not occur until after 1986 in the wake of falling international prices for petroleum. During the remainder of the 1980s, maximum foreign ownership was raised to 95 percent for export-oriented industries, and, more specifically, for projects involving high technology and foreign investment of over $10 million. During the remainder of the period up to 1992, other reforms to Indonesia's extensive web of foreign investment restrictions were gradually introduced, against the backdrop of simultaneous liberalization of many restrictive trade measures. For instance, in 1989 a negative list of sectors excluded from foreign direct investment was introduced, with a gradual reduction since then from 64 sectors to 35 sectors (in 1997), of which the most important remaining sector excluded from foreign direct investment is retail distribution.

Today, in the wake of the 1992 reforms, 95-to-100 percent foreign ownership of enterprises is permitted widely in Indonesia. Also, a number of so-called public interest sectors previously closed to foreign investment are now open to joint ventures. And, the

[57] The discussion of Indonesia's experiences with foreign direct investment here draws heavily on IFC (1997) and Pangestu (1995, 1997).

minimum foreign capital requirement, which had been in place since 1967, has been removed.

The pattern of foreign direct investment in Indonesia since the 1970s mirrors economic theory rather closely. Foreign direct investment rose during the late-1960s under the Open Door policy, but was heavily concentrated in the petroleum sector, where policies against long-term foreign ownership were less of a deterrent. As controls on foreign direct investment were tightened during the early 1970s, foreign direct investment fell sharply, and continued to fall in real terms throughout most of the decade as the policy climate for foreign investment steadily worsened. During the early 1980s, increased protectionism stimulated some FDI to exploit the large, protected Indonesian market. However, FDI only started to grow in real terms after 1986, when renewed liberalization of trade and investment policies was begun. It is also notable that since the mid-1980s foreign direct investment in Indonesia has been heavily weighted towards manufacturing for export markets, following the comparative (and competitive) advantage of Indonesia in labor-intensive manufacturing. This trend accelerated under the investment policy reforms of 1994, enabling Indonesia to share fully in the global surge of foreign direct investment to emerging-market countries with attractive policy environments until the advent of the current financial crisis in Asia.

Pakistan

Like other South Asian countries, at independence Pakistan adopted central planning and the import-substitution approach to industrialization. Today the legacy of central planning remains strongly imprinted on the country, a still sizable government bureaucracy, and many remaining public sector enterprises. Although Pakistan has made some of the largest strides among South Asian countries towards opening its economy to greater foreign direct investment (if not also to greater trade), studies of its experiences with reforms to foreign investment policies are not widely available.[58]

Not unlike Egypt, Pakistan has historically benefited from substantial foreign aid flows, which during the country's first decades of development provided largely unquestioning support for central planning and import substitution policies. In terms of growth, Pakistan was mainly successful during 1965-80, achieving an average annual growth rate of 5 percent. However, during the 1970s it became apparent in Pakistan, as in other South Asian countries, that inward-oriented development policies held limited potential for achieving higher sustained growth, necessary to address poverty reduction and to achieve other development goals. Thus, during the 1980s, with its South Asian neighbors Pakistan gradually began to adopt more outward-oriented development strategies, emphasizing export growth, openness to foreign capital and technology, and greater integration with the world economy (Bhagwati 1993).

[58] The discussion of Pakistan's experiences with foreign direct investment here draws principally on Khan (1998).

Today, protection and restrictions on foreign direct investment in Pakistan are significantly lower than a decade ago.[59] Import tariffs have been reduced to an average rate of less than 50 percent (still high by international standards), and reliance on nontariff barriers has been dramatically reduced. Also, the *Heritage Foundation/Wall Street Journal Index of Economic Freedom* ranks Pakistan currently among the most liberal low-to-middle-income countries worldwide in terms of foreign investment policies.[60] More extensively than other countries in South Asia, Pakistan has eased restrictions on foreign investment in the form of minimum domestic equity participation, has made more generous provisions for profit repatriation (and tax concessions), and has created export processing zones. The country has also taken leadership in expanding domestic equity markets, and opening these markets to foreign investors.

Unfortunately, the impacts of these positive steps towards greater integration with the world economy by Pakistan are difficult to discern because of the dominance of political events in Pakistan that have seen wide swings in dictatorial regimes and the commitment of policy makers to wider economic reforms and especially privatization. While private capital flows to Pakistan from abroad increased in value from the mid-1980s, their share in total flows to less developed countries actually fell, especially in the case of foreign direct investment flows. During the last decade (through 1995), real growth remained steady at about 5 percent per annum. During the same period, however, average annual growth of exports climbed to about 10 percent, compared to just 1 percent during the 1970s. Also during the last decade, manufactured exports as a share of total exports rose from just under 70 percent to 85 percent.

Yet, openness measured in terms of trade to GDP showed little gain during the last decade, presumably owing to still relatively high protection levels in Pakistan (like other South Asian countries). And, notwithstanding increased diversification of exports into manufactures, reported employment gains have been modest if not negative, suggesting low labor-intensity of industrialization in the aftermath of recent economic reforms. Against the backdrop of greater trade liberalization in other emerging-market countries, recent liberalization of foreign investment policies in Pakistan may have gone mainly to spurring greater tariff-jumping than outward-oriented foreign direct investment. Also, it has been suggested that, in comparison mainly to East and Southeast Asian countries, education and general development of human capital are importantly lacking in Pakistan (especially for women), limiting the potential for greater labor and total factor productivity gains necessary to attract more dynamic foreign direct investment to Pakistan.

[59] See, for instance, DeRosa (1998).
[60] See Holmes, Johnson, and Kirkpatrick (1998).

5. Recommendations for USAID-Funded Research and Analysis

Overview

As has been demonstrated in other emerging-market countries, foreign direct investment can be a useful partner for growth and development. If attracted by the right host-country policy environment, that is, a stable, inflation-free macroeconomic environment, along with outward-oriented foreign trade and investment regimes, foreign direct investment can play a substantial role in enhancing a country's international competitiveness. In contrast to policies that reward investments catering to the domestic market, embracing free trade and investment regimes opens the possibility for enticing FDI into expanding the base of manufacturing exports in a manner consistent with a country's current and evolving comparative advantage. The general export performance of the Egyptian economy and, in particular, the inability of the labor-abundant Egyptian economy to compete internationally in the production of manufacturing goods, constitute one of the key bottlenecks of the Egyptian economy today. Indeed, Egypt exhibits lower exports per capita than the worst performing countries in South Asia and Latin America. Foreign direct investment can be the catalyst for jump-starting exports and, in this way, for securing more dynamic integration with the new global economy. This strategy would augur well not just for the creation of more jobs and generation of foreign exchange, but also for more sustained and equitable economic growth, for adoption of technologies that help raise total factor productivity, and for alleviation of poverty.

Egypt offers important potential advantages for multinational enterprises seeking to establish competitive advantages worldwide, through outsourcing of intermediate goods and establishment of "export platforms" for producing and exporting goods at many different stages of the production chain. After so many years of hesitant macroeconomic reforms, the country has finally succeeded in stabilizing the economy. The fiscal accounts are balanced, and exchange rate stability has been achieved. Moreover, Egypt's geographical location – at the crossroads of the Middle East and North Africa – also gives strategic proximity to European markets. Finally, it features one of the largest populations in the MENA region and, as such, an important pool of labor, including large cadres of skilled workers and managerial talent. Against these advantages, however, there are impediments that cannot be ignored. One of the most important is that the process of foreign trade and investment liberalization is well behind that currently underway in other countries within and outside MENA. Arguably, more than investment, it is the trade regime that is in need of more decisive reform, as local and foreign investors must contend with high tariffs and numerous procedural restrictions on imports. Other key impediments include the fact that the country is lagging behind in the adoption of information technology and, most importantly, that the cost of doing business is far too high. In point of fact, foreign investors contend with confusing and non-transparent legal regimes, cumbersome requirements for establishment of firms and licensing of operations, unnecessary delays and red tape, and a bureaucracy that wields excessive discretionary powers.

In order to identify constraints to more dynamic performance of foreign direct investment and positive "spillover" effects on the Egyptian economy, this section proposes undertaking a medium-term USAID-funded program of research and analysis on the following seven topics, which, combined with elements of the present report, could form the nucleus for an economic conference or even a publishable volume on the importance of foreign direct investment for successfully propelling Egypt's integration in the new global economy and significantly enhancing its export performance:

(1) The first study will investigate and analyze the factors that contribute to the low degree of global production sharing that characterizes Egypt's external sector. It will also endeavor to make specific recommendations for removing impediments to FDI-led global production sharing in Egypt, following insights gained from reviewing the experiences of East Asian and other emerging-market countries.

(2) The second study will assess the impact of foreign direct investment on the Egyptian economy during the last decade or more, to determine if current FDI benefits conform to Egypt's development goals. The analysis is expected to contribute insights to how the government could better design and implement policies to maximize the benefits of foreign direct investment.

(3) The third study addresses the issue of transactions costs, which is so intimately linked to the high cost of doing business in Egypt. The analysis will identify and characterize the costs of exchange faced by foreign investors in Egypt versus emerging-market countries in MENA and should contribute to official U.S.-Egyptian discussions on the need to reduce transactions costs.

(4) The fourth study will examine non-traditional forms of foreign direct investment (NFDI), which cover a broad range of international investment projects for which foreign investors supply either tangible or intangible assets in exchange for shares in equity of host country firms. The study will assess the current extent of NFDI-financed operations in Egypt, their impact on the economy, and their potential for expansion. The study will also identify legal and economic constraints on this modality for foreign investment in Egypt, and make recommendations for removing the constraints identified.

(5) The fifth study focuses on the relationship between foreign direct investment and small and medium-sized enterprise (SME) development in Egypt. The theme is a core issue on the potential impact of FDI on host country economies as regards growth and a more equitable distribution of the spillover gains – diffusion of technical knowledge, capital, foreign exchange, administrative organization, and the like – *within* the host economies. SMEs can either be marginalized from or strategically linked with FDI. If the latter, the benefits for host countries will be enormous, given that SMEs constitute the bulk of business concerns and concentrate a large part of the workforce. The study purports to identify the key constraints – marketing, technological and, most especially, financial – that prevent SMEs from capturing the benefits from FDI.

(6) The sixth topic relates to the determinants of foreign direct investment in Egypt and other MENA countries, and proposes to investigate whether empirical support exists for openness to trade and other foreign exchange transactions as factors that positively explain foreign direct investment flows in these countries. To the extent that they do, the findings might be useful tools for U.S. officials in dialogue with their Egyptian counterparts who may be reluctant to embrace more decisively globalization and economic policy regimes more favorable to foreign direct investment.

(7) The seventh topic considers the relationship between foreign direct investment and regional integration agreements, such as the new Greater Arab Free Trade Area. While the creation of trading bloc agreements is conducive to expanding the size of the market and, consequently, to luring more FDI, it does not guarantee that more trade with the rest of the world will follow or that all member countries in trading bloc will share in any expansion of regional foreign direct investment. After reviewing the evidence on investment diversion and investment creation in regional economic cooperation agreements in Asia and the Western Hemisphere, the proposed analysis will analyze relevant data on production, foreign trade, and FDI in MENA countries, and consider the impacts on the Egyptian economy.

Scope of Work No. 1

Globalization and Worldwide Production Sharing by Egypt

Background and Objective

The sharing of different stages of manufacturing processes among countries is of major and growing importance. About $800 billion, or 30 percent, of international trade in manufactures are captured by global production sharing (Yeats 1998). In addition, trade in components and parts has been growing at a considerably faster pace than trade in finished products. This process started during the early 1960s, triggered by MNEs in search of networks of countries in which they could adapt specialized, labor-intensive production activities within vertically-integrated manufacturing industries, such as transport and machinery. MNEs first employed the Asian NICs, but now they are expanding this modality of FDI rapidly to other regions.

Several factors determine a country's participation in the global factory phenomenon. Among the most important factor is the existence of cheap, yet highly motivated and productive labor. Another is transport and distance. Small variations in international transport costs can have an important influence on the location of global production sites from which large volumes of output can be exported worldwide. In this vein, high transport costs appear to be one reason why Sub-Saharan Africa has generally failed to participate in global production sharing, in spite of their very low prevailing wages. Government policies, insofar as they act to increase or reduce commercial risk, are another important determinant. Countries in which internatonal shipping delays are the norm and which are characterized by labor and political unrest do not offer guarantees for vertically-integrated MNEs that can ill afford to halt international production owing to supply disruptions in a single production location.

Notably, Egypt enjoys comparative advantages as regards major factors determining global production sharing, such as low wages and close geographical location to one of the biggest markets of the world – the European Union. Still, there is evidence that the level of intra-industry trade in the Egyptian economy is very low, not only as compared to developed countries, but also many countries in MENA. This naturally raises questions about the obstacles that prevent the economy from specializing in a more diversified number of exports. One that stands out is lack of awareness by the private sector about the importance of manufacturing parts and components. The prevailing production "philosophy" in Egypt is to allocate resources for the manufacturing of final products, which naturally mirrors the poor development of intermediate goods industry in the country and limited technical knowhow to manufacture internationally competitive products for final consumption. To be sure, this is a by-product of long-lived policies that reward investments in sheltered domestic markets. Removing this obstacle is a process expected to take some time. It requires not only sustained government commtiments to institute a more open trade regime, but also increased awareness by domestic and foreign investors alike about the country's potential to participate more decisively in global production sharing.

The objective of the proposed study is twofold: (i) to determine and analyze the factors that contribute to the low degree of global production sharing that characterizes Egypt's external sector; and (ii) to prepare specific recommendations for the removal of official impediments. Such recommendations could be used by USAID for policy dialogue with the government of Egypt.

Scope of Work

The proposed study contemplates a brief discussion of the importance and advantages from participating in the global production sharing phenomenon, as evidenced from the rich lessons observed in other developing countries. This discussion will benefit from the pioneering work of Yeats (1998).

After this discussion, the study will concentrate on measuring the degree of global production sharing in the Egyptian trade structure, determining if this degree is adequate given the potential of the economy, and identifying the factors that prevent a more active participation by Egypt in global production sharing led by foreign direct investment. Egypt's degree of global producton sharing will be assessed with reference to the country's underlying industrial structure. However, measurement will of necessity involve data on international trade by Egypt using United Nations PC/TAS statistics on international trade (SITC Revision 2, preferably at greater than the 4-digit level of disaggregation) .

The empirical findings and inquiry into the factors that determine present levels of global production sharing in Egypt and other emerging-market countries will be the basis for preparing a set of policy recommendations.

Level of Effort

Two senior-level economists specializing in international trade and industrial economics, assisted by a data specialist, will be required to undertake the study. They would work together for 3 months simultaneously.

Scope of Work No. 2

Foreign Direct Investment in Egypt: Impacts and Benefits

Background and Objective

Most developing countries have now become aware of the advantages from liberalizing their economies to successfully face the challenges of globalization of the world economy. Egypt has not been an exception, as evidenced by measures taken recently that seek to further economic reforms and attract foreign direct investment. However, FDI inflows are affected through a myriad of policy instruments, including tax holidays and other incentives, some of which have proven to be costly and inefficient.

It is undeniable that attracting FDI is a primary and worthy goal. However, the principal issue should not be how to capture more inflows, but rather to maximize their potential benefits for the economy at large. As such, host governments should adopt a strategy that seeks maximum benefits from FDI in a manner consistent with their developmental goals. These potential benefits should be identified at the outset. For instance, foreign investors might be anticipated to contribute to the country's exports. They also stand to contribute to solving unemployment problems and idle resources by hiring local workers, creating new jobs, providing training, and the like. Strengthening intra and inter-industry linkages and contributing to diversification of the industrial base constitute other potential benefits, as well as enhancing the country's competitiveness and efficiency through wider market access, improvement of product quality, and competitive pricing of products. Last but not least, it is usually expected that transfer of technology is the most important return from FDI, particularly if it is applicable and appropriate to the characteristics of the host economy, and left to the competitive behavior of firms rather than mandated by performance requirements of one sort or another.

For all these reasons, host governments should view the FDI issue from a wider perspective. They should focus on how to benefit from FDI and not just on how to foster it. For Egypt, this has particular relevance, given that the impact from current flows of FDI, so far, does not match that achieved by countries that have clearly benefited from export expansion, technological diffusion, and job generation.

The objective of the study will be to assess the impact of FDI on the Egyptian economy during the last decade or more, with the purpose of determining if current benefits conform to Egypt's developmental goals. In addition, the study will develop a set of criteria for ideal FDI performance that will be matched against actual results. In light of the successful experiences observed in other countries with similar characteristics, the study anticipates that current benefits from FDI in Egypt fall well below potential. The analysis is expected to contribute insights into how the government could design and implement policy interventions aimed at maximizing benefits from FDI.

Scope of Work

The proposed study must gather primary data to evaluate sectoral distribution of FDI stocks and inflows, and review evidence on FDI's impacts on a set of variables that

include, at a minimum, technology transfer, export expansion, employment, and, as possible, backward and forward linkages. To carry this out, the study will seek the cooperation of FIAS to benefit from its database (believed to be under development) and from empirical studies undertaken by FIAS as well as other concerned institutions and agencies. The proposed study contemplates conducting questionnaires and field surveys, as deemed necessary, to supplement data collection.

The data will be analyzed and contrasted not only with the government's stated developmental goals, but also with an ideal benchmark of FDI performance. Findings from this analysis will be used to provide specific recommendations on what the government must do to capture more benefits from FDI.

Level of Effort

Two senior-level expatriate economists are recommended to undertake the study. One must be knowledgeable about FDI issues, particularly in developing countries. The other must be specialized in econometrics. The estimated level of effort is two months for each analyst. In addition, the study will require the participation of two local data specialists, one to assist in data collection and the other in data processing. These data specialists must have at minimum a master's degree in economics. Level of effort is one month each.

Scope of Work No. 3

Transactions Costs and Foreign Direct Investment in Egypt

Background and Objective

Foreign direct investment in Egypt has failed to achieve a sustained high level during the 1990s. Indeed, on a per capita basis, foreign direct investment in Egypt, at just over U.S.$10 per person, is several times less than the level of foreign direct investment found in most emerging-market countries (Table 1). Under its current economic reform program, Egypt has launched a number of legal and institutional reforms more conducive to attracting foreign direct investment. Also, significantly greater inflows of direct foreign investment might be expected to coincide with the completion of the privatization program presently underway. However, at larger issue in connection with the poor performance of foreign direct investment in Egypt are high transactions costs found in the Egyptian economy – that is, high costs of engaging in exchange throughout the economy and especially with the public sector.

High transactions costs significantly magnify investment and operating cost estimates for turnkey and other projects in Egypt. As a consequence, despite Egypt's abundance of low-wage labor, Egypt remains a "high cost" country. Under more normal levels of transactions costs, foreign firms would more actively consider investment opportunities in Egypt, including opportunities to establish "export platforms" to produce labor-intensive goods for distribution to not only the world at large but especially Europe and the other two continents at whose crossroads Egypt is strategically located: Asia, and Africa.

High transactions costs in the Egyptian economy will not fall substantially until the still extensive government intervention in the economy and the bureaucratic rent-seeking that government intervention and too often ponderous (and uncertain) enforcement of national laws and regulations makes possible are significantly reduced and even supplanted by competitive private sector providers of goods and services, under thoroughgoing privatization of not only commercial and industrial sectors but also possibly some sectors traditionally producing public goods and services. The Egyptian legal system must also be reformed, to become less ponderous in its adjudication of disputes over private property rights and contracts, and its enforcement of court decisions.

The objective of this study will be to identify and characterize the costs of exchange faced by foreign investors in Egypt versus emerging-market countries in MENA and the rest of the world. The analysis is expected to contribute additional insights to the extraordinary costs to foreign (and domestic) firms of investing and conducting business in Egypt, and so contribute to general public discourse and official U.S.-Egyptian discussions on the need to reduce transactions costs in the Egyptian economy in order to attract greater foreign direct investment to Egypt.

Scope of Work

For the study, the relevant exchanges would include traditional legal and other institutional requirements for domestic market entry by a foreign firm, such as licensing and company registration, costs of labor relations and training, and import barriers facing essential imported inputs. However, the scope of relevant exchanges would be expanded to include indicators of general transactions costs in an economy, for instance, for housing, telecommunications, and financial and legal services, following, for instance, the recommendations and general methodology outlined by Benham (1997).

The final list of relevant exchanges for analysis might be developed on the basis of not only review of possibly similar studies in the economic (and business development) literature but also consultations with foreign investment associations and organizations located in Egypt and abroad, such as the American Chamber of Commerce in Egypt, its parent in Washington, D.C., and the International Finance Corporation and its subsidiary FIAS (Foreign Investment Advisory Service) both in Washington, D.C.

To the extent possible, the study will employ consistent data compiled from international sources such as the World Bank, UNCTAD, and perhaps specialized international associations devoted, for instance, to the provision of commercial or legal services in emerging-market countries. Also, a methodology will be developed to systematize and rank the compiled data (or other information) in such a way that magnitude of transactions costs in Egypt can be compared readily to the magnitude of transactions costs in other sample countries, and that policy-relevant conclusions can be drawn from the results of the analysis.

Level of Effort

The proposed study will require 3-to-4 person months of effort contributed by one or more senior level economists or business policy analysts familiar with the issue of transactions costs in emerging-market countries, and with statistical methods appropriate to the proposed study. The ideal study investigator(s) would have relevant experience with an international management or investment consulting firm. The study might be undertaken collaboratively by an expatriate analyst and an Egyptian counterpart.

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Scope of Work No. 4

Non-Traditional Forms of Foreign Direct Investment

Background and Objective

Foreign direct investment has traditionally been effected principally through foreign investors acquiring existing firms or incorporating new enterprises in host countries. What statistics fail to show, however, is the variety of new modalities of FDI that have been gathering impetus since the late 1960s, and which are now playing a more important role in North-South economic exchanges. These new modalities are termed "non-traditional FDI" (Oman 1984).

Non-traditional FDI (NFDI) covers a broad range of international business operations that have a common denominator: investment projects in host countries not necessarily “owned” by foreign investors, but for which they supply either tangible or intangible assets. Most often, NFDI involves exchange of these assets for shares in equity of host country firms. Partial or total control over the project depends on how essential these assets are, and on what legal form that the investment would take.

NFDI includes licensing agreements, management contracts, franchising, turnkey and "products-in-hand" contracts, production sharing and risk-service, and international subcontracting. Some of these forms have proven their importance in East Asian countries, in agriculture and manufacturing sectors. In sum, NFDI could play an appreciable if not major role in modernizing Egypt’s production sectors, especially its small and medium enterprises, and spur the expansion of exports. For this to materialize, it is necessary that new legal arrangements be incorporated in the Trade Law.

The objective of the proposed study is to assess the current extent of NFDI operations in Egypt, and to assess the potential to expand them. The study will identify legal and economic constraints that impede more dynamic development of this modality for foreign investment in Egypt and propose recommendations to remove the constraints identified.

Scope of Work

After a brief discussion of the importance of NFDI and review of successful experiences with NFDI in East Asian countries, the study will concentrate on analyzing how NFDI is conducted in Egypt. Specifically, a firm-level survey will be conducted. Findings will also serve to identify constraints and to assess the potential for further development of NFDI.

Level of Effort

Two senior economists: one economist with an excellent background in the experiences of East Asian countries with foreign direct investment and in technology-transfer through NFI, and the other economist specialized in industrial organization. A lawyer specialized in contracts involving transfer of technology is highly recommenced to join the work in this project.

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Scope of Work No. 5

Foreign Direct Investment and Development of Small and Medium-Sized Enterprises in Egypt

Background and Objective

Not unlike other developing countries, small and medium-sized enterprises (SMEs) contribute significantly to output creation and employment generation. Of all business concerns in the country, it is estimated that 90 percent is composed of SMEs. In general however, these entities face constraints that smother their growth and development potential. In particular, the high transactions costs that permeate the business environment in Egypt hinders operations more severely SMEs than the larger concerns and conglomerates. Most SMEs are handicapped by small markets, inadequate marketing networks, use of outdated technologies, costly and unreliable procurement of inputs of production, excessive regulation and by lack of access to formal financial services.

As the evidence of the Veneto and Emilia Romagna regions of Italy vividly shows, it is not necessary that economic development proceeds along the traditional lines of capital intensive, large fixed-cost production units. An alternative strategy concentrates in strengthening the technological capabilities of SMEs and in facilitating their sustained access to financial services so as to achieve their more dynamic integration with both domestic and international markets. This happens either when SMEs involved in manufacturing light consumer goods attain productivity levels necessary to turn out low-priced, high-quality goods. It also occurs when these SMEs become strategically linked tp larger conglomerates that outsource to them the production of parts and components of a final product, and that at the same time provide the critical linkage to wider markets. Under this latter modality, the larger conglomerates facilitate the diffusion among SMEs of technology and finance. All this paves the way for the creation of a virtuous economic circle whereby equitable growth and sustained increases in total factor productivity can be furthered.

The benefits derived from FDI can be either appropriated by MNEs or shared with the host economy. Under strategies that foster FDI into the exploitation of natural resources, and also trade and FDI regimes that favor the development of inward industrialization, it is more likely that the host-country gains will accrue to small groups within the country. This has been amply demonstrated by the Latin American experience as regards industrial protection, whereby benefits were normally concentrated in urban areas and among those formally employed. But the implementation of more outward regimes opens the possibility of distributing benefits more evenly both between MNEs and host countries and within social groups of the latter, especially if the indigenous input and managerial supply response to the new economic opportunities triggered by FDI is agile and dynamic. To be sure, under more outward trade and investment regimes, there is no guarantee that positive externalities will spillover to the host economies. But effective economic policy *beyond* the safeguarding of an enabling macro environment, that is, policies aimed at eliminating barriers to market entry, deregulation, strengthening

social and economic infrastructure, and at favoring the development of human capital, are decisively important to capture the gains.

The challenge for Egypt is not only to capture more FDI but to ensure that its benefits will be tangible and equitable distributed in the economy. Opening more economic opportunities for SMEs and, most importantly, facilitating the expansion and strengthening of their linkages with both domestic and foreign investors, is a sure way to achieve this goal. Experiences from other countries are rich and illustrative. Within Latin America, Colombia, one of the countries first in adopting open trade regimes, since the 1960s, saw the emergence of SMEs as competitive exporters in regional markets. More recently, Chile's SMEs engaged in agricultural and agribusiness have expanded international sales by virtue of their being strategically linked with MNEs. On the other hand Mexico, a country long characterized by the policies of exclusion of large segments of its population has failed, so far, to incorporate SMEs into the dynamic development that has been made possible by NAFTA and open trade and FDI regimes. As a result, benefits are still concentrated and FDI has not moved beyond labor-intensive operations. In Asia, Malaysia offers an example of how indigenous firms producing machine tools are strategically linked with foreign electronics MNEs and how they have evolved into world class exporters.

The objective of the study will be to identify main constraints that block the development of SMEs in Egypt as regards their potential linkages with both domestic and foreign investors, and to propose concrete policy recommendations so as to remove the impediments. The study will enable USAID officials to vouch for more liberalized regimes with findings and policy recommendations aimed at fostering equitable distribution of benefits from FDI. It must be noted that in Egypt the legacy of state planning and distrust of FDI associated with it has not been rooted out completely. The study will thus be a tool to convince Egyptian officials of the advantages from advancing reforms simultaneously both in the external and SME sectors.

Scope of Work

The study will undertake first a brief review of the literature on successful linkages of SMEs with FDI. Thereafter, the identification of constraints will be explored. To do so, a survey addressed to SMEs, and domestic and foreign firms will be prepared.

Special emphasis will be placed on investigating financial constraints, that is, constraints in the access, or lack of access, of SMEs to formal financial services. It should be underscored that the financial sector of Egypt is still dominated by state banks. While a number of SMEs probably have access to these entities, it is probably correct to state that the vast majority does not. This impinges negatively on their capability to secure working capital finance at reasonable cost and on timely basis. The study, therefore, will bring to light the urgency for further reform in the country's financial sector. In addition, the study will explore and analyze alternative ways of financing, such as supplier credit (from MNEs for example) and evaluate its potential.

Other constraints that will be analyzed include the cost and reliability of information on SMEs, marketing channels, and access to training and modern management techniques and institutional arrangements for the transfer of technologies.

Level of Effort

The proposed study will be undertaken by an expatriate economist, experienced in issues of SME finance and development, in collaboration with an Egyptian economist. A research assistant to aid in conducting the survey is also recommended. In terms of level of effort, four person months are recommended for the economists and 2 person months for the research assistant.

Scope of Work No. 6

Determinants of Foreign Direct Investment in MENA: An Exploratory Empirical Analysis

Background and Objective

Observers in not only Egypt but also other less developed countries have frequently questioned the benefits of foreign direct investment, especially outward-oriented FDI in the new global economy with its renewed emphasis on neoclassical fundamentals such as relative abundance of primary factors (especially low-cost labor) as determinants of foreign investment as well as trade. In particular, there is not widespread acceptance among policy makers and their economic advisors that foreign direct investment flows propelling the growth of international trade today are truly responsive not only to fundamental economic circumstances of less developed countries such, as relative factor endowments, per capita income, and distance from major markets (and FDI source countries) but also to economic policy regimes in host countries, especially as policy regimes impinge on freedom of transactions for international trade and foreign exchange.

The objective of this study is to investigate whether empirical support exists for neoclassical explanations of foreign direct investment in less developed countries in an exploratory econometric analysis of the determinants of foreign direct investment in less developed countries that explicitly incorporates data for Egypt and other MENA countries as well as developing countries world wide that are more prominently hosts to foreign direct investment flows. To the extent that measures of openness to trade and other foreign exchange transactions, and possibly measures of low transactions costs in the domestic economy, are found to be among the positive and significant determinants of foreign direct investment, greater support for adoption of liberal and open economic policies to attract greater foreign direct investment might be brought to bear in USAID policy dialogues with Egyptian and other officials who are reluctant to embrace globalization and the necessity in the world economy today of reducing impediments to long-term foreign investment by multinational enterprises in Egypt and other emerging-market countries in MENA.

Scope of Work

The proposed study will undertake a brief review of recent empirical studies of the determinants of foreign direct investment and, based on the review, adopt an appropriate econometric methodology for pursuing an original econometric analysis of the determinants of foreign direct investment in a broad sample of emerging market countries including Egypt and other prominent MENA countries. In addition to fundamental economic variables identified in previous theoretical and empirical studies, the study will explicitly include among the explanatory variables of the analysis variables representing elements of the policy and business environment for foreign direct investment, such as indicators of openness to foreign trade and investment, and regulatory stringency and domestic transactions costs.

Hufbauer, Lakdawalla, and Malani (1994), and the references cited therein (especially Caves 1982 [1996]), provide one possible starting point for review of the econometric literature on explaining foreign direct investment flows. Their empirical analysis also provides a useful example of the so-called gravity model approach to investigating the determinants of foreign direct investment flows to competing host countries using econometric methods and bilateral FDI data at five-year intervals during 1980-90 for three major countries with large multinational enterprises investing abroad: Germany, Japan, and the United States.

Level of Effort

The proposed study will require 3-to-4 person months of effort contributed by one or more senior level economists familiar with both econometric methods and current economic issues surrounding foreign direct investment and its linkages to trade in emerging-market countries. The study will be undertaken through the collaboration of an expatriate economist and an Egyptian economist, with the assistance of one research assistant. The study will require a small amount of special funding for extraordinary data or econometric software.

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Scope of Work No. 7

Foreign Direct Investment and Regional Integration Arrangements in MENA

Background and Objective

Against the backdrop of the new global economy, regionalism has emerged widely around the world during the last decade, offering countries in close proximity to one another opportunities to expand their mutual economic relations following, it is frequently argued, a less ponderous and less time-consuming route than presented by the example of the Uruguay Round of multilateral trade negotiations, which required 7-to-8 years to reach a (relatively modest) trade liberalization agreement among more than 125 countries. With increasing prospects for peace in the Middle East, countries in the MENA region are increasingly looking to possibilities for expanding economic opportunities through adoption of economic cooperation pacts among themselves. Bilateral free trade agreements between the European Union, on the one hand, and several individual MENA countries, on the other hand, have already been adopted under the so-called Mediterranean free trade initiative (Hoekman and Djankov 1996; Galal and Hoekman 1997), and the Arab League has recently announced plans to form a Greater Arab Free Trade Area to link the economies of several Arab states in MENA more closely together, through a preferential trading arrangement (DEPRA 1998).

It is frequently suggested that regional integration arrangements expand opportunities for foreign direct investment as well as trade. Specifically, by expanding local markets, regional integration attracts foreign direct investment by multinational enterprises that are anxious to establish efficient, large-scale operations in prosperous and expanding regions around the world. While tariff-jumping might remain an element of MNE behavior, FDI attracted to regionally integrated areas, it is argued, tends to be larger-scale and more outward-oriented than FDI attracted to the same areas in the absence of regional integration arrangements.

Such arguments in favor of FDI under regional integration arrangements are appealing, but they are not necessarily borne out by closer economic reasoning, and consideration for differences in real world types of regional integration arrangements. To be sure, in expanding the size of regional markets, economic integration of neighboring countries should be expected to expand investment activity and rationalize location of production facilities within a region. In doing so, however, some members of the regional integration arrangement might attract disportionate volumes of new investment, leaving other member countries, particularly those that initially are more highly protected (and hence less integrated in the world economy), with little or even reduced foreign investment. Also, although investment stimulated by adoption of a regional integration arrangement might be more outward-oriented than before, greater outward-orientation of this investment might be limited to the boundaries of the region rather than the larger global economy, in effect, responding to market opportunities presented by regional import-substitution policies, not the market opportunities of the global economy presented by nondiscriminatory trade liberalization (e.g., Blomstrom and Kokko 1997).

The "hub-and-spoke" design of the EU partnership agreements illustrate some further difficulties surrounding investment "creation" and "diversion" under regional integration arrangements. Under the EU partnership agreements, investment should be expected to be concentrated in the hub of the "free trade" system – namely, the European Union – because the hub of the regional integration arrangement is the only location with duty-free access to markets in all member countries (in addition to tariffs, a thoroughgoing analysis would also have to take into account domestic content requirements enforced under the free trade area). Thus, although the EU partnership agreements might be expected to promote appreciable new investment in Europe, Egypt and other MENA countries might be confronted, *ceteris paribus*, by greater investment diversion than investment creation.

Scope of Work

The proposed study will review the economic theory and evidence on dynamic effects of regional integration arrangements. In the latter vein, it will particularly examine what evidence may be available about the experiences with investment creation and investment diversion under prominent free trade areas and other forms of regional economic cooperation agreements in Asia (e.g., Asean/Afta and Apec) and the Western Hemisphere (e.g., Nafta and Mercosur).

The theoretical and empirical evidence gathered will then be related to information about current and proposed regional integration arrangements in MENA, with special emphasis on the expected impacts of MENA-wide economic integration arrangements on Egypt. Although precise quantification of the impacts, through economic modeling or other forms of applied analysis, might not be possible, the analysis might still be undertaken with reference to relevant data on production, foreign trade, and foreign investment in MENA countries, to illustrate rough orders of magnitudes of potential outcomes for key variables such as foreign trade and investment. For comparative purposes, the analysis should also consider the impacts on foreign trade and investment under greater integration of Egypt and other MENA countries with the world economy, for instance, through nondiscriminatory trade liberalization under a new round of WTO/GATT trade talks or, simply, an accelerated program of general trade liberalization in MENA countries.

Level of Effort

The proposed study will require 3-to-4 person months of effort contributed by one or more senior level economists familiar with the economic literature on regional integration arrangements and foreign direct investment, and foreign trade and investment relations in not only the MENA region but also other major regions of the world. The study will be undertaken jointly by an expatriate economist and an Egyptian economist.

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Table 1.1. Net Foreign Direct Investment in Egypt and Other Emerging-Market Countries, 1990-96

	1990	1991	1992	1993	1994	1995	1996
				Millions of U.S. Dollars			
Egypt, Arab Rep.	734.0	253.0	459.0	493.0	1,256.0	598.0	636.0
East Asia							
China	3,487.0	4,366.0	11,156.0	27,515.0	33,787.0	35,849.0	40,180.0
Hong Kong, China	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Indonesia	1,093.0	1,482.0	1,777.0	2,004.0	2,109.0	4,348.0	7,960.0
Korea, Rep.	788.0	1,180.0	727.0	588.0	809.0	1,776.0	2,325.0
Malaysia	2,333.0	3,998.0	5,183.0	5,006.0	4,341.8	4,131.5	4,500.0
Philippines	530.0	544.0	228.0	1,238.0	1,591.0	1,478.0	1,408.0
Singapore	5,574.7	4,887.1	2,204.3	4,686.3	8,367.6	8,209.8	9,440.2
Thailand	2,444.0	2,014.0	2,113.0	1,804.0	1,366.0	2,068.0	2,335.9
South Asia							
India	162.0	74.0	277.0	550.4	973.3	2,143.6	2,587.0
Pakistan	244.0	257.2	335.0	346.0	419.0	719.0	690.0
Sri Lanka	43.0	48.0	123.0	195.0	166.0	56.0	119.9
Latin America							
Argentina	1,836.0	2,439.0	4,045.0	2,555.0	3,068.0	4,181.0	4,285.0
Brazil	989.0	1,103.0	2,061.0	1,292.0	3,072.0	4,859.0	9,889.0
Chile	590.0	523.0	699.0	809.0	1,773.0	1,668.0	4,091.0
Colombia	500.0	457.0	729.0	959.0	1,667.0	2,317.0	3,322.0
Mexico	2,634.0	4,762.0	4,393.0	4,389.0	10,972.0	9,526.3	7,618.7
Peru	41.0	-7.0	136.0	670.0	3,083.5	2,035.1	3,580.8
Venezuela	451.0	1,916.0	629.0	372.0	813.0	985.0	1,833.0
Middle East & Africa							
Israel	100.6	350.5	538.6	579.9	442.3	1,588.2	2,110.3
Jordan	38.0	-12.0	40.7	-33.5	2.9	13.3	15.5
Morocco	165.0	317.0	422.0	491.0	551.0	290.0	311.0
South Africa	-89.0	-219.0	-41.0	-17.0	333.7	330.9	136.3
Turkey	684.0	810.0	844.0	636.0	608.0	885.0	722.0
Zimbabwe	-12.0	3.0	15.0	28.0	35.0	40.0	63.0

Table 1.1 (Cont.). Net Foreign Direct Investment in Egypt and Other Emerging-Market Countries, 1990-96

	1990	1991	1992	1993	1994	1995	1996
			U.S. Dollars Per Capita				
Egypt, Arab Rep.	14.00	4.72	8.38	8.81	22.01	10.28	10.73
East Asia							
China	3.07	3.79	9.58	23.35	28.37	29.79	33.06
Hong Kong, China	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Indonesia	6.13	8.17	9.63	10.68	11.05	22.42	40.39
Korea, Rep.	18.38	27.27	16.65	13.35	18.20	39.47	51.05
Malaysia	130.40	218.15	276.25	260.62	220.87	205.58	218.82
Philippines	8.47	8.49	3.48	18.45	23.17	21.03	19.58
Singapore	2,060.90	1,768.76	782.24	1,630.59	2,855.85	2,748.98	3,101.23
Thailand	43.97	35.65	36.85	31.07	23.26	34.81	38.93
South Asia							
India	0.19	0.09	0.31	0.61	1.07	2.31	2.74
Pakistan	2.17	2.22	2.81	2.82	3.32	5.53	5.17
Sri Lanka	2.53	2.78	7.07	11.06	9.29	3.09	6.55
Latin America							
Argentina	56.45	73.99	121.07	75.46	89.42	120.25	121.66
Brazil	6.68	7.34	13.50	8.34	19.55	30.52	61.28
Chile	45.04	39.27	51.61	58.75	126.69	117.38	283.73
Colombia	14.87	13.34	20.91	27.01	46.11	62.94	88.70
Mexico	31.55	55.94	50.63	49.65	121.90	103.99	81.76
Peru	1.91	-0.32	6.07	29.30	132.12	85.44	147.43
Venezuela	23.13	95.93	30.77	17.79	38.03	45.09	82.16
Middle East & Africa							
Israel	21.59	70.82	105.13	110.23	81.92	286.42	370.75
Jordan	11.99	-3.39	10.90	-8.58	0.71	3.17	3.59
Morocco	6.86	12.92	16.86	19.24	21.17	10.93	11.51
South Africa	-2.62	-6.33	-1.17	-0.48	9.17	8.95	3.62
Turkey	12.19	14.14	14.45	10.69	10.04	14.36	11.52
Zimbabwe	-1.23	0.30	1.46	2.66	3.25	3.63	5.60

Source: World Bank, *World Development Indicators*, cd-rom, 1998.

Table 2.1. World Share of Exports and Imports
(US$ billion)

Country/Region	**Exports**		**Imports**	
	1980	**1996**	**1980**	**1996**
G-7 a/	53	52	49	46
Other OECD b/	14	13	15	13
Asian NICs c/	5	13	5	14
Latin America d/	4	4	4	4
Mena e/	0.5	0.3	1	0.8
Rest of the World	23.5	17.7	26	22.2
Total	100	100	100	100

a/ United States, Canada, Japan, Germany, Italy, France and United Kindgom
b/ Australia, Austria, Belgium, Netherlands, Spain, Sweden and Switzerland
c/ China, Hong Kong, Korea, Singapore, Malaysia and Thailand
e/ Egypt, Jordan, Lebanon, Morocco, Syria, Tunisia
d/ Argentina, Brazil, Chile, Colombia, Mexico and Venezuela
Source: Compiled from World Development Report (1998).

Table 2.2. World Share of FDI Inflows (percentages)

Country/Region a/	**1986-91 (average)**	**1997**
G-7	58	40
Other OECD	18	13
Asian NICs	5	17
Latin America	4	12
Mena	0.7	0.4
Rest of the World	14.3	17.6
Total	100	100

a/ Country composition of each group follows the classification of Table 1
Source: Compiled from UNCTAD (1998)

Table 2.3. Net Private Capital Flows to Developing Countries
(US$ billion)

Item	**1970**	**1980**	**1990**	**1992**	**1994**	**1996**
Bank lending	3.5	45.6	12.3	26.5	11.6	36.4
Bonds and Equity	-----	2.6	6.7	27.3	67.1	91.4
FDI	2.3	5.1	25.0	46.6	80.1	118.9
Total	5.8	53.3	44.0	100.4	158.8	246.7

Source: Compiled from World Development Indicators (1998) and World Bank Tables

Table 2.4. FDI Outflows, Outward Stock, and Total Assets: Growth Rates (percentages)

Item	1986-90 (average)	1991-95 (average)	1996	1997
Outflows	27.1	15.1	-0.5	27.1
Outward Stock	21.0	10.3	11.5	13.7
Total Assets a/	18.3	24.4	12.0	13.0

a/ Of foreign affiliates
Source: UNCTAD (1998)

Table 2.5. Internationalization through FDI (percentage of world output)

Item	1980	1990	1996
FDI Stock a/	9.5	15.8	21.4
FDI Flows b/	1.0 c/	-------	2.2 d/

a/ Inward plus Outward Stock
b/ Inflows plus Outflows
c/ Average of period 1980-82
d/ Average of period 1994-96
Source: UNCTAD (1998)

Table 2.6. Regional Distribution of Inward and Outward FDI Stock
(percentages)

Country/Region	**Inward FDI Stock**		**Outward FDI Stock**	
	1985	**1997**	**1985**	**1997**
United States	24.4	20.9	36.4	25.6
Japan	0.6	1.0	6.4	8.0
Europe a/	33.6	36.9	44.4	50.4
Developing Countries	27.7	32.0	4.3	9.9
World	100	100	100	100

a/ Includes European Union and other Western European countries
Source: UNCTAD (1998)

Table 2.7. MNEs: Selected Indicators
(billions of U.S. dollars; percentages)

Item	**1982**	**1997**
Total Assets a/	1869	12606
Total Sales	2440	9500
Gross Product	559	2100
Exports a/	569	1961
Gross Product/World Output	5.3	6.9
Exports/World Exports	27.7	32.3 b/

a/ Of foreign affiliates
b/ 1995
Source: UNCTAD (1998)

Table 4.1. FDI Trends in Egypt

Year	Foreign Direct Investment, n.i.e LE millions
1975	Na
1976	Na
1977	105
1978	318
1979	1216
1980	548
1981	753
1982	294
1983	490
1984	729
1985	1178
1986	1217
1987	948
1988	1190
1989	1250
1990	734
1991	253
1992	459
1993	493
1994	1256
1995	Xx
1996	Xx

Source: IFS Yearbook 1996
(if you have data to fill 1995, 1996 in hormony with the table's figure, please send them to me to draw the graph)

Table 4.2. Average annual FDI inflows to 10 largest LDC recipients, 1970-1994
(Millions of dollars)

Host country or area	1970-1980	Host country or area	1981-1990	Host country or area	1991-1994
Brazil	1390	**Mexico**	2442	**China**	19295
Mexico	743	**Singapore**	2341	**Singapore**	6587
Singapore	386	**China**	1885	**Argentina**	5558
Malaysia	381	**Brazil**	1662	**Mexico**	5381
Nigeria	219	**Taiwan province of China**	1467	**Malaysia**	4634
Egypt	205	**Hong Kong**	1402	**Indonesia**	2066
Indonesia	194	**Malaysia**	1105	**Hong Kong**	1564
Hong Kong	162	**Egypt**	878	**Thailand**	1440
Argentina	121	**Thailand**	734	**Brazil**	1399
Algeria	120	**Argentina**	700	**Nigeria**	1228
Percentage in total flows to developing countries and areas	67.0		71.9		88.2

Source: UNIDO, Industrial development global report 1996**.**

Table 4.3. Objectives of 20 U.S. Firms Operating in Egypt
(Responses to Questionnaire)

Objective	Percentage of firms 1/
Production mainly for exporting	15%
Production mainly for local market	50%
Sales of technology and services	40%
Distributor	10%
Sales Office	25%
Other forms of shared/joint risks	20%

Source: American Chamber of Commerce in Egypt, *Private Investment in Egypt*, 1995.
1/ Figures in column may add to more than 100 percent.

Table 4.4. Nominal and Effective Protection Rates, 1997
(Percentages)

Activity	NPRj	INRPi	ERPj
Agriculture	**7.14**	**4.81**	**6.81**
1. Agricultural Food Products	6.82	5.04	6.62
2. Agricultural Non-Food Products	9.49	6.08	9.63
3.Livestock Products	5.11	3.31	4.17
Manufacturing	**27.37**	**7.62**	**34.22**
4. Food Processing	6.87	2.23	6.39
5. Beverages	271.64	11.34	-1781.7
6. Tobacco Processing	85.00	-1.92	88.47
7.Cotton Ginning	5.01	7.96	-10.89
8. Spinning and Weaving	27.95	7.67	47.55
9. Final Wear	46.64	14.56	55.86
10. Leather and Leather Products (excl. Footwear)	31.13	17.43	47.57
11. Footwear	39.10	15.54	50.81
12. Wood and Wood Products (excl. Furniture)	8.64	10.41	6.10
13. Furniture	49.90	8.19	83.80
14. Paper and Printing	17.05	5.47	17.84
15. Chemicals (excl. Petroleum Refining)	10.01	2.65	9.20
16. Petroleum Refining	11.81	-1.56	14.76
17. Rubber and Plastic Products	28.47	6.21	43.07
18. Porcelain, China and Ceramics	35.04	6.19	55.95
19. Glass Products	20.65	9.91	23.20
20. Non-Metallic Products	15.18	6.23	18.52
21. Steel, Iron and Metallic Products	16.06	7.68	18.06
22. Machinery and Equipment	15.30	6.57	14.49
23. Means of Transport	43.97	2.83	55.62
24. Other Manufacturing	18.14	8.92	18.52
Average (excl. Beverages and Petrol. Ref.)	24.62	7.23	30.48
Standard Deviation	19.51	4.50	26.93

Sources: DEPRA (1998b) and Kheir-El-Din (1998).

Notes: NRPj equals nominal rate of protection for activity j; INRPI equals implicit nominal rate of protection on material inputs i to activity j; and ERPj equals effective rate of protection for activity j.

Table 4.5. Relation between Growth and FDI Inflows

Country	average 1974-1979				Average 1980-1989				average 1990-1995			
	FDI		GDP growth rate		FDI		GDP growth rate		FDI		GDP growth rate	
	$ million	rank	%	rank	$ million	rank	%	rank	$ million	rank	%	rank
Egypt	28407	2	907	1	89707	2	508	2	63202	4	106	5
Malaysia	46308	1	704	2	96409	1	507	1	444407	1	809	2*
Thailand	8405	3	702	3	50802	3	703	3	196802	2	809	1*
Tunisia	6903	4	607	4	15608	5	306	5	331,0	5	405	3
Turkey	5400	5	4.4	5	16803	4	403	4	74405	3	402	4

*the ranking is according to the second decimal.

Source: calculated from the data of W.B, CD-ROM 1997

Table 4.6. Manufacturing Projects Approved by the General Authority for Investment
(Cumulated Data through June 30, 1997)

		(1)	(2)		(3)		(4)	(5)	(6)		(7)
	Manufacturing Industry subsections	**Number of projects**	**Equity (planned capital)**		**New Employment Opportunities**		**Average Size of the Project**	**Investment cost per worker (LE 000)**	**Foreign Capital Sectoral Share**		**Foreign participation in projects(%)**
			Value (L.E. million)	% of total	Number	% of total			Value (L.E. million	% of total	
1	Textile manufactures	391	2307	10	95769	25	5.9	47	402	9.4	17.4
2	Food processing	639	2914	13	67338	17	4.6	84	739	17.2	25.4
3	Chemical products	824	6249	28	70256	18	7.6	182	1169	27.2	18.7
4	Wooden products	198	351	2	12284	3	1.8	53	16	0.4	4.6
5	Engineering products	525	3150	14	58344	15	6.0	114	525	12.2	16.7
6	Construction materials	365	3776	17	37616	10	10.3	229	758	17.7	20.1
7	Metal products	332	2272	10	29613	8	6.8	155	248	5.8	10.9
8	Medical products	127	1217	5	16789	4	9.6	140	437	10.2	35.9
	Total	3401	22236	100	388027	100	6.5	178	4294	100	19.3

Column (4) = equity (2)/ number of projects (1)
Column (5) = total investment costs (not in the table) / employees
Column (7) = value of foreign share (6) / equity (2)

Source: Mahboub (1998)

Table 4.7. Foreign Capital Shares in Approved Investment Projects
(Accumulated data until December 31, 1996; Values in LE million)

Economic Sectors	(A) Equity (planned capital)	(b)Foreign share in capital by sectors		(c)Foreign participation in projects' capital
	Value	value	% of total	%
Industry	16537	3455	47.6	21
Agriculture	1391	61	0.8	4
Tourism	11015	1071	14.7	10
Services	1853	217	3.0	12
Construction	923	21	0.3	2
Finance	11657	894	12.3	8
Total Inland	43376	5719	78.7	13
Total free zones	5726	1548	21.3	27
Total projects	49102	7267	100	15

Column C = B as % of A.
Source: Mahboub (1998)

Table 4.8. Real Effective Exchange Rate and Domestic Prices
(1991=100)

		Domestic Prices	
Year	REER 1/	Tradables CPI	Non-Tradables CPI
1985	61	34	52
1986	60	40	55
1987	57	50	61
1988	51	60	67
1989	57	72	73
1990	83	88	85
1991	100	100	100
1992	93	119	127
1993	81	126	158
1994	79	137	174
1995	78	152	183

Source: World Bank. 1997. *Arab Republic of Egypt, Country Economic Memorandum. Egypt: Issues in Sustaining Economic Growth. Main Report, Volume II*. The World Bank. Washington, D.C.

1/ Real effective exchange rate. A decrease in the index indicates real appreciation of the Egyptian Pound.

Table 4.9. Revised Index of Speed of Integration

	Average annual changes of the four components as percentages of the initial values				Revised Speed of Integration Index 1981-83 to 1991-93
	Population adjusted trade ratio	Institutional investor rating	FDI as a share of ppp GDP	Manufact-uring export share	
China	3.99	-1.31	68.33	0.87	0.14
Egypt	-29.51	-2.00	-7.02	28.32	-0.71
Indonesia	-11.97	-0.09	17.50	77.13	0.34
Jordan	46.77	-3.36	-7.14	2.08	-0.35
Korea, Rep.	5.85	2.31	15.71	0.29	-0.12
Philippines	26.44	0.32	21.00	5.58	0.04
Thailand	48.36	2.01	16.43	13.26	0.40
Tunisia	-3.65	-1.08	-5.30	8.46	-0.58
Turkey	24.59	8.74	41.43	7.73	0.84

Table 4.10. Effects of Four Components on the Speed of Integration

Country	Average of the rates of change of the four components (1)	Relative Effect (%) of pop-ulation adjusted trade ratio on the speed of Integration Index (2)	Relative Effect (%) of institutional investor rating on the speed of Integration Index (3)	Relative Effect (%) of FDI as a share of ppp GDP on the speed of Integration Index (4)	Relative Effect (%) of manufacturing export share on the speed of Integration Index (5)
China	17.97	5.56	-1.82	95.06	1.21
Egypt	-2.55	-289.07	-19.57	-68.73	277.37
Indonesia	20.64	-14.49	-0.11	21.19	93.41
Jordan	9.59	121.97	-8.76	-18.63	5.42
Korea, Rep.	6.04	24.23	9.56	65.03	1.18
Philippines	13.34	49.56	0.61	39.37	10.46
Thailand	20.01	60.41	2.51	20.52	16.56
Tunisia	-0.39	-231.27	-68.58	-335.36	535.22
Turkey	20.62	29.81	10.59	50.22	9.38

Source: Abdel-Latif and Selim (1998), Table 2.

Table 4.11. FDI and Exports of Manufactures

	1970	1975	1980	1985	1990	1991	1992	1993
(I) Foreign direct investment, net inflows (% of GDP)								
China	0.000	0.000	0.000	0.544	0.983	1.159	2.668	6.372
Egypt, Arab	0.000	0.070	2.392	3.396	2.074	0.772	1.291	1.253
Indonesia	0.860	1.481	0.231	0.355	0.955	1.156	1.277	1.268
Jordan	..	..	..	0.501	0.945	-0.286	0.798	-0.607
Korea, Rep.	..	..	..	..	..	..	..	..
Philippines	-0.373	0.654	-0.326	0.039	1.196	1.199	0.430	2.275
Thailand	0.607	0.148	0.587	0.419	2.854	2.050	1.898	1.444
Tunisia	1.101	1.034	2.688	1.284	0.617	0.964	3.377	3.848
Turkey	0.324	0.244	0.026	0.147	0.454	0.536	0.531	0.353
(II) Manufactures (% of merchandise exports)								
China	..	41.8	47.5	35.9	61.6	75.7	78.7	80.6
Egypt, Arab	27.1	34.1	10.9	10.1	32.4	30.7	35.3	32.9
Indonesia	1.2	1.2	2.3	11	35.5	40.8	47.5	53.1
Jordan	..	..	..	..	..	..	..	..
Korea, Rep.	76.5	81.4	89.5	91.3	93.5	91.7	92.8	93.1
Philippines	7.5	11.7	21.1	26.6	39	69.8	41.3	41.6
Thailand	4.7	14.7	25.2	38.1	63.1	65.5	66.8	71.1
Tunisia	1.1	19.6	35.7	44.5	69.1	68.9	72.9	75.1
Turkey	8.9	23.3	26.9	61	67.9	65.8	71.3	71.8

Source: Abdel-Latif and Selim (1998), Table 9.

Table 4.12. Foreign Investment Codes in Egypt and Competing Countries

Country	Financial incentives					Non-Financial incentives		
	Tax incentives			Highest marginal tax*	Non-tax financial incentives	Investment procedures	Free market environmt	Other incentives +
	Exemption period	Tax rate during exemption	Profits taxed during exemption					
Egypt	Automatically available for 5 years & for 10 years for projects outside the valley	Zero -rate	Total profits	40%	Not available	Simpler than before	available	……
Indonesia	Not available except in very limited cases			30%	Tariff and trade facilities & development of industrial banks & major developments in the financial markets & steps to minimize and share economic and financial risk.	simple	available	available
Thailand	Limited availability for export projects for 3-8 years			30%	Reduction in tariffs for export activities	simple	available	available
Tunisia	Automatically available for 5 years. For 10 years for activities related to technology development and environment protection	Zero -rate	100% for 5-10 years & 50% after for unlimited period according to project type	35% in general (20% for wholly-exporting activities**)	Reduction in tariffs & investment bonus(up to 8%) & contribution in R&D-training- energy saving-feasibility studies	simpler than before	available	available
Turkey	Limited availability according to some criteria		30-100%	25%	Tariff reduction for export activities & low-rate loans & investment bonus(up to 20%)	simpler than before	available	available
China***	Very limited availability	Not defined	Not defined	30%	Balance of foreign exchange for some special cases	simpler than before	available	….
Malaysia	Limited availability for projects of priorities for 5-10 years	Zero- rate	7% -15%	34%	Tariff cut for export activities & some cuts of special types of costs (marketing, R & D) from tax base	simple	available	available
Israel	Not available	Not applicable	Not applicable	36%	Investment bonus up to 38% & low-rate loans for export activities & marketing promotion fund & substantial cash assistance for R&D & wage subsidies	simple	available	available

Sources: DEPRA (1997), Table 5.5, based on Tunisia, *Investment Code 1993*; China, *Investment Code for Foreign Capital 1986*; Israel, *Israel Means Business, 199X*.

* World Bank 1997,World Development Indicators.

** Tunisia, Investment Code 1993; Egypt, The Unified Investment Code 1997; Soliman, S. et al. 1997, Incentives of industrial investment, CEFERS (unpublished).

*** China, Investment Code for Foreign Capital 1986.

\+ Other incentives such as marketing and loan guarantee, training, and accelerated depreciation, mostly available in these countries, but not necessarily all of them in the same time.

Table 4.13. Incentives and Obstacles to FDI in MENA Emerging-Market Countries

Incentives	Obstacles
Egypt	
--Largest potential market in MENA region. (per capita equals $1,050 in 1995).	--Retains socialist policy mindset with Public Sector still dominant in many areas of economy.
--Strategically located at the meeting point of the Middle East and North Africa and close to European markets.	--Pace of macroeconomic reforms and trade/investment liberalization well behind those of comparison countries.
--Large trainable, productive available labor base.	--Confusing, multiple, inconsistent, and non-transparent legal regimes affecting foreign investment, incentives, and company formation with tedious and costly implementing procedures.
--After slow start, gradually liberalizing trade and investment.	
--Leader in Middle East regional economic integration initiatives and could become an industrial/sales platform for the region.	--Significant and effective bureaucratic, union, and sectoral opposition to privatization and trade liberalization.
--Exchange rate and financial stability.	--Huge bureaucracy that operates arbitrarily with excessive discretionary authorities, delays, and unnecessary red tape.
	--Inefficient infrastructure.
Turkey	
--One of the largest markets in the world.	--Persistent political and economic instability, which contributes to unpredictable policies and an uncertain business climate.
--Average per capita GDP only $2,680 but as much as $15,000 in urbanized Western Turkey.	--General perception of government mismanagement of the economy: taxes evaded ($60 billion in 1995) are three times more than taxes collected; continuing and growing government deficits; inflation between 70% and 100% annually; and government economic and other statistics considered unreliable.
--Recent Customs Union with the EU provides access to the Euro-market.	
--Commercial crossroads for the EU, Central Asia, and the Middle East and potential headquarters and operations center for all these markets.	--Government has been slow to undertake legal/economic reforms to harmonize EU systems under a customs union.
--Euro-oriented human resources both in numbers and skills of workers with high productivity.	--Commercial legal system considered outdated and dilatory with no effective alternative dispute resolution system in place. Continued widespread state ownership of industries.
--Turkey has never defaulted on any of its debts.	

--Dynamic economic growth averaging 5.5% per year since 1990.

--Favorable treatment of foreign investors, including remittance freedom.

--Privatization is proceeding slowly with an apparently inadequate basis in law and legislation.

--Some allegations that government bureaucracy discriminates against foreign-owned companies in regulatory and tax enforcement.

--New BOT/BOOT law considered inadequate to accomplish Government's infrastructure development goals.

Israel

--Market access possibilities under Israel's free trade agreements with the European Union, EFTA, and the United States.

--Strong industrial/financial complex with advanced technology base and infrastructure.

--Good physical infrastructure.

--Well-educated, technologically- skilled, highly productive, labor base.

--Geographically located in the center of the Middle East with a high degree of trade complementarities for regional integration.

--National treatment and generous incentives for foreign investors.

--Depressed investor confidence regarding Middle East peace prospects and regional economic integration.

--Strong government intervention in the economy and control over key sectors (chemicals, shipbuilding, electricity, air transport, telecommunications, etc.).

--Small (though affluent) domestic market.

--High labor costs and benefits compared to other MENA nations.

--High tax structure (direct, indirect) unless investor qualifies for incentives.

--Very high non-tariff trade barriers, particularly for food products.

Morocco

--Political stability and continuity, insulated from political and religious unrest.

--Progressive liberalization of economic and investor-related policies.

--Geographical proximity to Western Europe and possibilities as regional sales/service platform for North Africa and Sub-Saharan Africa.

--Well-developed public infrastructure including ports and inland transportation ("best road network in Africa").

--Continuing privatization program, open to foreign investors.

--Outdated, non-transparent judiciary without effective alternative dispute resolution.

--Arbitrary and non-transparent Customs administration.

--"Sluggish" bureaucracy.

--Allegations of discrimination against companies in tax administration.

--Application of protective tariff bands to agricultural imports and conversion of import licensing and quotas into tariff equivalents at up to 300%.

--National treatment for foreign investors and freedom to remit profits.

Tunisia

--Generally liberal, market-based economy.

--Partnership with EU calls for free trade in 12 years and enhanced access to EU market.

--Stable political, social, and economic structure and society.

--Relatively affluent middle-class dominated economy (79% own their own homes).

--Adequate and improving physical infrastructure.

--Very effective one-stop-shop facilitation of company establishment and investment incentives applications.

--Rigid labor laws and a labor/management dispute system that favors labor.

--Exchange availability limited to with Central Bank approval required for current account transactions (must prove lack of local source).

--Concerns expressed about level of intellectual property rights protection and enforcement.

--Judiciary not viewed as independent of Government pressures.

--Cumbersome bureaucracy with dilatory administrative decision making.

--Concerns about potential impacts of political/religious turmoil in neighboring Algeria and Libya.

--Weak banking sector.

Source: DEPRA (1997).

Table 4.14. FDI Inflows, 1990s (US$ million)

Country	1990	1991	1992	1993	1994	1995	1996	1997
Argentina	1836	2439	4012	3261	3107	4783	5090	6326
Chile	661	822	935	1034	2583	2978	4724	5417
Mexico	2549	4742	4393	4389	10973	9526	9185	12477
Peru	41	-7	136	670	3084	2000	3226	2030
Venezuela	451	1916	629	372	813	985	2183	5087

Source: CEPAL (1998)

Table 4.15. Argentina: FDI Stock by Economic Sector (percentages)

Sector	**1980**	**1992**
Agriculture	2.1	3.6
Mining and Petroleum	12.7	6.5
Chemicals	11.9	12.9
Transport Equipment	14.8	15.7
Other Manufacturing	36.1	24.5
Finance and insurance	9.0	17.1
Other Services	13.3	19.7
Total	100.0	100.0

Source: IRELA (1996).

Table 4.16. Chile: FDI Stock by Economic Sector (percentages)

Sector	**1980**	**1995**
Agriculture	2.9	2.7
Mining	45.5	56.1
Manufacturing	30.9	15.4
Finance and Insurance	13.3	8.1
Other Services	7.4	17.6
Total	100.0	100.0

Source: (IRELA 1996)

Table 4.17. Mexico: FDI Inflows by Economic Sector (percentages)

Sector	1981-93	1994-96	1997
Primary	2	---	---
Manufacturing	49	57 a/	61 b/
Finance	---	11	6
Services	49	32	33
Total	100.0	100.0	100.0

a/ Principal subsectors and their weight on *total* FDI inflows were: foodstuffs and beverages (12%), chemical products (9%), metals ((7%), and machinery and equipment, including the auto industry (24%).
b/ Principal subsectors and their weight on *total* FDI inflows were: foodstuffs and beverages (36%), chemical products (1%), metals (1%), and machinery and equipment, including the auto industry (20%).
Source: CEPAL (1998)

Table 4.18. Peru: FDI Stock by Economic Sector (percentages)

Sector	**1980**	**1995**
Agriculture	0.7	0.1
Mining and Petroleum	43.1	20.8
Manufacturing	34.3	13.6
Transport and Communication	0.5	42.1
Finance and Insurance	5.6	8.2
Other Services	15.8	15.2
Total	100.0	100.0

Source: IRELA (1996)

Table 4.19. Venezuela: FDI Stock by Economic Sector (percentages)

Sector	1980	1995
Machinery	18.3	18.2
Chemicals and Plastics	15.2	12.0
Foodstuffs and Beverages	14.5	10.1
Other Manufacturing	13.7	17.5
Finance and Insurance	10.8	23.4
Other Services	25.8	15.7
Total	100.0	100.0

Source: IRELA (1996)

Appendix: Abstracts of Key Studies

Section 1

DEPRA (Development Economic Policy Reform Analysis Project). 1998a. *International Competitiveness of Egypt in Perspective: First Report 1998*. Development Economic Policy Reform Analysis Project, and Research Information Sector, Egyptian Ministry of Economy. Cairo, Egypt.

This report, which is prepared jointly by members of the USAID-funded DEPRA Project and research staff of the Egyptian Ministry of Economy, review's Egypt's recent economic circumstances and performance with the objective of assessing the current and prospective competitiveness of Egypt in the global economy. It also aims at providing an analytical and empirical baseline to serve as a foundation for future reports in the series. Using an approach to measuring international competitiveness patterned after that employed by the World Economic Forum, the report concludes that, along with accelerated privatization of state-owned enterprises and institutional reforms to reduce high transactions costs in the Egyptian economy, faster and more thoroughgoing trade liberalization in Egypt is essential for promoting more rapid and significant structural adjustment of the Egyptian economy in line with Egypt's comparative advantage in labor-intensive manufactures and even some labor-intensive agricultural commodities and products. Such acceleration of Egypt's trade and other policy reforms, the report further concludes, would benefit not only Egyptian workers but also Egyptian private-sector firms and entrepreneurs anxious to be at the forefront of Egypt's emergence as full-fledged member of the new global economy. 86 pages.

Section 2

Streeten, P. 1996. Globalization and Competitiveness: Implications for Development Thinking and Practice. In L. Emmerij, ed., *Economic and Social Development into the XXI Century, pp107-147*. Inter American Development Bank. Washington, D.C.

By a leading development economist, this article discusses the current trends of economic integration and economic interdependence and the impact on the developing countries. The author contends that the benefits and costs of increasing globalization are uneven. First, he suggests that globalization has benefited East and Southeast Asia, but not the Latin American countries (with the exception of Chile), South Asia and Africa. The former are countries with economic institutions that adapt more rapidly to changing international conditions, whereas the latter do not show such flexibility. They are rigid, reluctant adjusters. Not surprisingly, East and Southeast Asian countries have pursued outward oriented industrialization and are therefore capable of selling technically sophisticated products to world markets. The bulk of the developing counties, on the other hand, still depend on commodity exports. Second, unemployment rates are at all-time historical records in *both developed and developing countries*. Within countries, globalization seems to benefit more the educated, professional,

managerial, technical and all those independent of public services at the expense of workers with few skills and people dependent on the civil service. One consequence is that income distribution within countries has become more uneven. This inequality is reproduced internationally: capital, know-how, enterprise, management, and marketing are highly mobile internationally and are combined with domestic semi-skilled or unskilled labor which is much less mobile across national borders. Third, and especially since the early 1980s, globalization favors creditors more than debtors. This was evident during the Latin American debt crisis of the 1980s and with the collapse of the Mexican peso in 1994.

The author argues that the main institution of our time the nation state cannot cope with the revolutions in transport, travel, communication and information that have transformed the world. He calls for the establishment of participatory institutions capable of overseeing *globally* competition policy, energy, taxation, the environment, health and the like. In finance, global institutions should be capable of recycling current-account surpluses to foreign exchange starved countries and of managing a global debt facility. He argues that victims of the international competitive struggle (that increasing globalization entails) must be assisted by a safety net provided by the state. Finally, he calls for the design of strategies that can select and encourage the positive aspects of globalization while minimizing the negative ones and cushioning the losers in the process.

Coffey, W. J. 1996. The newer international division of labour. In P.W. Daniels and W. F. Lever, eds., *The Global Economy in Transition, pp 40-61*. London: Longman.

The article surveys the evolution of the international division of labor, and discusses its dimension in the global economy, as well as the factors that helped shape its development. The author identifies the most recent phase of this process as the newer international division of labor (NIDL), which is characterized by the emergence of subcontracting as a form of FDI, the shift from manufacturing of goods to the provision of services, the emergence of outwards investments among the newly industrialized countries (NICs) and the increase in cross-investment among core economies. The author also recognizes the transfer from developed to developing countries of both, technically standardized and fragmented processes of production systems, and the manufacturing of products that have reached the mature phase of their cycle. All this is shaped by MNE activity through its decision to invest or not to invest in particular countries, and through the resulting international flows of raw materials and finished goods which are increasingly subject not to external market prices, but to internal transfer of MNEs. While MNEs are key actors of the NIDL, the extent to which they can pursue their strategies is limited by the attitudes of governments in host countries.

McKinnon, Ronald I. 1991. *The Order of Economic Liberalization. Financial Control in the Transition to a Market Economy:* Baltimore. Johns Hopkins University Press.

In the early 1970s, the author pioneered an analysis of how over-regulated and state-controlled financial markets harms resource allocation and economic growth. Then came the banking collapse in the late 1970s suffered by Argentina, Chile and Uruguay which precisely tried to implement free market policies in finance. These crises were precipitated by overvalued exchange rates, over-indebtedness by the private sector, excessively high real lending rates, and lack of adequate bank supervision. In this book, the author provides a blueprint for the appropriate sequencing of the liberalization process which factors in the pitfalls in the liberalization experiments of those South American countries. The book is addressed to transition economies but also to all developing countries that are still struggling with high fiscal deficits, macroeconomic instability, widespread state ownership of industries and banks, and trade protection. The author argues that the first task of financial liberalization should be the balancing of government s finances, which should be enacted simultaneously with a far reaching trade reform, including the unification of the exchange rate, imposition of low tariffs, and elimination of all quantitative restrictions on imports. Once these two objectives have been achieved, he recommends the liberalization of the domestic financial markets via the lowering of legal reserve requirements on bank deposits, the elimination of barriers to domestic bank competition, and the reduction of subsidized and targeted credit to preferred economic sectors. Foreign banks should also be allowed in. Finally, the capital account should be opened only after all these reforms have been consolidated, including the establishment of bank prudential norms and efficient bank supervision. If anything, the book provides a useful exposition of the dangers from a too rapid elimination of capital controls in developing countries. 200 pages.

Akyüz, Yilmaz and Günther Held, eds., 1993. *Finance and the Real Economy: Issues and Cases Studies in Developing Countries*. Economic Commission for Latin America and the Caribbean, United Nations Conference onTrade and Development and World Institute for Development Economics Research. Santiago, Chile.

By the Chief, Macroeconomics Section, Global Interdependence Division of UNCTAD (Akyüz) and the Coordinator, Regional Joint Project ECLAC/UNDP Financial Policies for Development (Held). The book contains six papers on financial policy issues and country experiences. Akyüz argues that in modern examples of industrialization such as Southeast Asia finance serves industry and trade, and not vice versa. Financial liberalization often gives rise to deepening, but the latter is not always associated with a better use of resources, especially when financial instability and fragility undermine both productive and allocative efficiency. Prudential regulation, while necessary, may not always be sufficient to prevent instability in developing countries when financial liberalization leads to escalation of interest rates and excessive risk taking. In analyzing the outcome of different financial policy experiences in Latin America and the Caribbean, Held argues that the emergence of bank solvency problems in a sample of nine countries in the region shares the common condition of severer flaws in prudential regulation and supervision. Other contributors to this volume

include Alice Amsden (Korea and Taiwan), Machiko Nissanke (Sub Saharan Africa), Donald Hanna (Indonesia) and Andras Uthoff (Chile). Amsden provides a description and rationale of extensive government intervention in financial markets of the two leading Asian NICs. In these countries, the focus of financial policies has been to keep the cost of investment finance low. Nissanke examines the factors impeding financial intermediation and mobilization of household savings in Ghana, Kenya, Malawi and Zambia. Hanna focuses on the financial and real effects from removal of interest rate ceilings, credit expansion, reduction of allocative role of credit by Central Bank, and capital account liberalization. Hanna argues that these policies were successful, notwithstanding the fact, unlike McKinnon s standard prescription, the capital account was opened simultaneously with the enactment of reforms. 290 pages.

Hausmann, Ricardo and Liliana Rojas-Suárez, eds., 1996. *Volatile Capital Flows. Taming their Impact* on *Latin America*. Inter American Development Bank. Washington D.C.

By the Chief and Deputy Chief Economist of the Inter American Development Bank, the volume contains two parts. Part I discusses the macroeconomics of capital flows in Latin America and Part II ways to achieve stability in Latin American financial markets in the presence of volatile capital flows. The authors recognize the enormous potential that world financial markets have for promoting economic development. As such, the recovery of investment and growth in Latin America following the debt crisis of the 1980s would have been much more difficult had it not been for the renewal of capital inflows in the early 1990s. At the same time, world financial markets can be very volatile. Dire consequences follow when inflows fall or reverse themselves. When this happens, an increase in domestic interest rates and a decline in asset values typically follows. This may have adverse implications for domestic investment and therefore could generate a sharp contractionary impulse to the economy. The reduction of capital flows will also require a depreciation of the real exchange rate, with implications for employment and production in the tradables and nontradables sectors, and creating the need for costly reallocations of resources. Since adjustment to reversal of inflows is not trouble free, policy makers should take steps to insulate their economies from shocks without jeopardizing their domestic economic and social goals. Key policy issues include introducing more flexibility in exchange rate policy, targeting fiscal surpluses during normal times, and strengthening prudential norms and supervision of domestic banking systems. 107 pages.

Section 3

Borensztein, E., J. DeGregorio, and J.W. Lee. 1999. How does foreign direct investment affect economic growth? *Journal of International Economics* 45: 115-135.

This paper tests the effect of foreign direct investment on economic growth in a cross-country regression framework, utilizing data on foreign direct investment flows from industrial countries to 69 developing countries during 1970-89. The empirical results suggest

that foreign direct investment is an important vehicle for the transfer of technology, contributing relatively more to growth in developing countries than domestic investment. However, the higher productivity of foreign direct investment holds only when the host country has a minimum threshold stock of human capital. In addition, foreign direct investment has the effect of increasing total investment in the economy more than one for one, suggesting the predominance of complementarity effects with domestic firms.

Caves, R.E. 1974. Multinational firms, competition, and productivity in host-country markets. *Economica* 41(162): 176-193.

This paper empirically investigates the benefits of foreign direct investment in the manufacturing sectors of two leading host countries, Canada and Australia. Specifically, it tests several hypotheses about the effects of foreign direct investment on domestic-owned firms competing with foreign subsidiaries. Profits of Canadian manufacturing industries show a weak tendency to vary inversely with the foreign share. With regard to technical efficiency and transfer of new technology, subsidiary shares in Canadian industry are found to be unrelated to crude measures of relative productivity levels for manufacturing industries as a whole, possibly owing to high Canadian tariffs. However, in Australia's manufacturing sector, higher subsidiary shares are found to coincide with higher productivity levels in competing domestic firms. Unfortunately, these conclusions are limited by poor quality of data, and the difficulty of empirically verifying the precise dynamic mechanism linking subsidiaries' market share to their relative level of productivity.

Caves, R.E. 1996. *Multinational enterprise and economic analysis: Second edition*. Cambridge: Cambridge University Press.

By a leading international trade and industry economist, this volume surveys contributions of theoretical and empirical economic analysis to understanding why multinational enterprises exist and what consequences they have for the workings of national and international economies. It also considers economic policies that affect multinational enterprises, highlighting sources of potential discrepancies between impacts on national and world economic welfare from a public policy perspective. Among other well-considered chapters, the volume includes separate chapters focusing on multinational enterprises and models of international economic activity, productivity and technology transfers, and multinational enterprises in developing countries. The volume also includes an extensive bibliography, through the mid-1990s, of economic studies on multinational enterprises and foreign direct investment. 322 pages.

Dunning, J.H. 1993. Multinational enterprises and the global economy. New York: Addison-Wesley.

By a leading scholar of international business and a prime consultant to UNCTAD Programme on Transnational Corporations, this volume is an especially comprehensive study examining the interaction between international activities of corporations and the countries in which they operate, emphasizing the interface between competitive advantages of MNEs and the competitive advantages of source and host countries. Written from an interdisciplinary perspective rather than strictly economic perspective, it draws on historical, theoretical, and empirical materials, compiled from the 1950s to beginning 1990s. Most important, it presents and evaluates these materials using Dunning's analytical framework known as the eclectic or OLI paradigm of international production, investment, and trade. 687 pages.

Helpman, E. and P.R. Krugman. 1985. Market structure and foreign trade: Increasing returns, international competition, and the international economy. Cambridge, Massachusetts: MIT Press.

Widely regarded as a seminal contribution to international trade theory, this book undertakes to provide an integrated approach to the analysis of international trade in a world characterized by increasing returns and imperfect competition. Accordingly, it breaks with standard neoclassical trade theory in very fundamental ways, following the so-called new trade theory pioneered by Krugman and others. The theory developed in the book explains trade patterns, especially of industrial countries, and, among other contributions, provides an exploratory framework for analyzing the role of multinational enterprises in international trade. 271 pages.

International Finance Corporation. 1997. *Foreign direct investment*. Lessons of Experience No. 5. Washington, D.C.

This IFC monograph articulates the lessons of IFC's experience in advising countries, especially less developed countries, on appropriate policies for attracting foreign direct investment in the new global economy marked by increasingly close integration of national economies, driven by worldwide competitive pressures, economic liberalization, and opening of new areas for international investment. It includes an extensive chapter on types of restrictions to foreign direct investment, and getting the policy environment right in developing countries. 119 pages.

Moran, T.H. 1998. Foreign direct investment and development: The new policy agenda for developing countries and economies in transition. Institute for International Economics. Washington, D.C.

This new volume presents one of the most comprehensive studies on foreign direct investment to appear in a number of years, and usefully focuses on FDI impacts and policies in developing countries. The volume synthesizes evidence drawn from case studies of foreign direct investment in LDCs in three major industries (with sharply different factor and technology intensities) – petrochemicals, automobiles and auto parts, and electronics and computers – to show that full-scale foreign plants integrated into the global sourcing netwrik of the parents provide benefits to developing countries that are far in excess of the capital, management, and marketing requirements commonly assumed. With regard to investment policies in host countries, the analysis takes exception to investment promotion, requirements for joint ventures, domestic content, and export performance, and technology-licensing mandates in these countries, arguing that such policies are economically costly and most often result in inappropriate long-term foreign investment for the dynamic as well as static comparative advantage and other characteristics of the host country. Finally, the volume envisions that the interests of both capital-exporting countries and capital-importing countries would be served by a "Grand Bargain" that eliminates investment distorting measures in both advanced and less developed countries. 191 pages.

WTO (World Trade Organization). 1996. Trade and foreign direct investment. *WTO annual report, 1996*. Geneva.

This paper survey the extensive literature on the economics of foreign direct investment, focusing especially on the interaction of trade and foreign direct investment, including the impact of foreign direct investment on the trade of source and host countries, and the implications of competition for foreign direct investment among host countries. The paper's coverage and discussion of recent empirical and case studies of the impacts of foreign direct investment are especially well developed. Legal, institutional, and other WTO-related issues surrounding foreign direct investment are also considered. 37 pages.

Section 4

Egypt and MENA

American Chamber of Commerce in Egypt. 1998. *Egypt: The Emerging Market*. Cairo, Egypt

The paper indicates that FDI flows into Egypt are likely to exceed 1 billion dollar per year, and that the country is expected to rank among the top 10 host developing countries in attracting FDI. (There are more than 400 MNEs operating in Egypt in the fields of

petroleum, manufacturing, tourism and banking). It shows that the ability of Egypt to attract foreign capital has also been greatly facilitated by progress in privatization during 1996.

The paper reveals that while investments flows continue to be large and diversified, increased competition and rising saturation of the domestic market have led multinational enterprises operating in Egypt to look for export markets in the region and beyond, (there are now well over 500 successful joint ventures operating in Egypt across petroleum, banking and tourism sectors, as well as all branches of manufacturing). The study points out three factors that are behind this outwards orientation trend: reforms of trade policy which have made Egyptian exports more competitive; Egyptian productivity that has risen by over 50 percent, while dollar wages have been constant for the past decade, thus reducing the unit labor cost to the lowest in the Mediterranean region; and development of the domestic private sector as regards size, strength and managerial ability.

American Chamber of Commerce in Egypt. 1994. *Impediments to the Private Sector Development in Egypt*. Cairo, Egypt.

This paper summarizes the main impediments to private sector development in Egypt. These include economic policy unpredictability, that is, unclear rules of the game that dampen private sector confidence. Confidence is also undermined by an outdated legal system and weak law enforcement. Also, the bureaucratic system in Egypt shows technical and process inefficiencies in dealing with the private sector. Judicial litigation in Egypt is expensive and time consuming due to understaffing, low technical capacity, poor facilities and limited financial resources. Egypt's savings are low, in part because the tax treatment of non-corporate firms limits their saving capacity. The corporate tax rate is high (42%) and rules for tax holidays are not clear. In all, the time-consuming, inefficient process of filing tax returns adds an element of uncertainty. Not surprisingly, there is distrust between the tax authority and taxpayers. As regards human resources the critical problem is the scarcity of skilled workers and managers, as well as the absence of career development programs within organizations. Private sector operations are limited by the presence of the state both as the largest player and as an institutionalized monopoly. The export sector is plagued by regulatory and structural constraints in accessing markets, keeping abreast of consumer trends as well as achieving high quality standards in products and packaging.

El Erian, M. and M. El Gamal. 1997. Attracting Foreign Investment to Arab Countries: Getting the Basic Rights. *Working Paper* 9718. Economic Research Forum. Cairo, Egypt.

This study is concerned with differentiating between different kinds of FDI incentives that are conducive to generate benefits for host countries. It considers "good" incentives of FDI to include: Policies that foster macro economic stability and predictability; a high degree of openness in the economy; a tax structure which encourages equity and direct investment financing and does not give excessive benefits to debt financing; and public investment and

encouragement of private investment in infrastructure and the social sectors. Whereas bad incentives are: Preferential exemptions from trade barriers, preferential exemptions from tax liabilities. The study shows that the final effect of FDI attracted by bad incentives is likely to be: (1) failure of the policy of protecting domestic infant industry, which presumably initially justified the trade restrictions; (2) increased domestic consumption, and a reduction in domestic saving and investment (3) a deterioration in the balance of trade due to the increased imports of intermediate goods and (4) a potential net capital outflow due to profit repatriation by MNEs subsidiaries. The study proceeds by presenting policy implications based on a study including Algeria, Egypt, Morocco, Jordan, Syria and Tunisia, focusing on FDI incentives and flows for the period 1985-94. It concludes that Arab countries, although relatively generous in offering incentives for foreign investment, have failed to attract high levels of FDI, partly, due to the failure of these countries to maintain a conducive "enabling environment for investment and saving." Improving this situation requires; (1) the establishment of a sound microeconomic environment; (2) deep structural reforms; (3) improving social sectors performance; and (4) strengthening the institutional base.

Makharita, R. 1995. International Business as a factor of Economic Growth. *Taba Conference on Mediterranean Business Media*. July.

The paper reveals that the awareness in developing countries of the importance of trade liberalization as an engine for economic growth has pushed them to adopt economic reform programs. Also the GATT Uruguay round has been enhancing liberalization. Accordingly, it is anticipated that FDI will play a positive role in such a competitive global world. However, the paper argues that the FDI phenomenon is greatly determined by an appropriate business environment. Such an environment requires institutional adjustment as well as economic adjustment. Also, transaction costs should be reasonable and competitive structures in factor, goods and services markets should be furthered.

Fawzy, S. 1998. The Business Environment in Egypt. Mediterranean Development Forum II, Marrakech, Morocco.

This paper is based on the findings of a survey of a random sample of firms conducted early in 1998 in order to identify the most binding institutional constraints to private sector operations in Egypt. It also provides a detailed analysis of these constraints across different economic activities, firm size and ownership structure.

The paper reveals that the private sector is still playing a relatively limited role, given the large and dominant size of the government (share of government expenditure in GDP was 28% in 1996). It also concludes that both economic and institutional reforms are required for the private sector to flourish. The slow pace of privatization, high tariff levels, young stock market, and underdeveloped insurance and pension funds are among the factors that hamper private sector efficiency. Concerning the institutional climate, the following factors need to

be reformed: tax administration, the judicial system, support services, and education and vocational training.

SRI (Stanford Research Institute). 1998. Aid to Trade, The Growing Role of Export Growth in Egypt. Paper presented at "Expanding Egyptian Exports," USAID Economic Growth Workshop, Cairo, Egypt, October19, 1998.

This papers begins by defining "aid to trade" as a process of transition, with emphasis in the bilateral economic affairs between two nations, from one predominantly based on donor-recipient relationship, to one grounded primarily on mutually-beneficial commercial ties. It shows that the "aid to trade" process depends on some important factors, most importantly the replacement of government agencies with private sector entities as central actors in the bilateral economic relationship. Consequently, this requires that aid-recipient countries concentrate on launching appropriate economic and commercial policies, as well as establishing and developing institutional structures to support those commercial activities. The paper illustrates international experiences and empirical evidence of countries that have adopted this "aid to trade" process, such as Malaysia, Korea and Taiwan. It develops a "commercial policy model" measuring the extent to which commercial policies are "business friendly," whereby nations are scored on 32 policy variables classified under 9 categories: business start up, price level, interest rates, import, export, foreign exchange, domestic investment, foreign investment, labor, and taxation. The study applies this model to Egypt's case, which in turn is compared to other Middle East nations so as to determine how well the country fares as regards competitiveness-conducive policies.

DEPRA (Development Economic Policy Reform Analysis Project). 1997. *Egypt: A Comparative Study of Foreign Direct Investment Climates*. DEPRA, Egyptian Ministry of Economy and International Cooperation. Cairo, Egypt.

This paper reviews several studies and reports that relate to FDI impediments. It also discusses current and past laws and regulations directly or indirectly affecting the FDI regime in Egypt and other countries -- Turkey, Israel, Morocco, and Tunisia. These comparisons cover the business climate for FDI, government economic policy, macro economic trends, and the legal/regulatory regime. Finally, the paper provides general recommendations for the Egyptian economy in order to achieve a more favorable business climate as well as FDI specific recommendations aiming at enhancing the climate for foreign investors (national treatment, rationalization of investment-related laws, reduction of bureaucratic discretion and red tape, and adopting intellectual property rights).

FIAS (Foreign Investment Advisory Service). 1991. Egypt's Foreign Direct Investment Climate. Cairo, Egypt.

This study addresses the FDI climate in Egypt. It is based on data on FDI trends and surveys that point to FDI impediments. It brings to light the experience of other countries – Indonesia, Turkey and Tunisia -- which faced the same problems as Egypt but were able to overcome them and succeeded in fostering export-oriented FDI. The surveys show that the main impediments facing foreign investors are non-appropriate macroeconomic environment, an inadequate investment policy framework, a large role played by state enterprises, and a high degree of bureaucracy.

The study reveals that Egypt -- relative to the previously mentioned countries -- has been slow in implementing economic reform programs and has suffered, for a long time, from an overvalued real exchange rate. The public sector still plays a dominant role within the economy, draining the government treasury, making Egypt less competitive internationally due to higher prices and lower quality of public goods. The study shows that Egypt's red tape is one of the main factors discouraging foreign investors and that there is a general complaint by most investors that bureaucracy is among the main obstacles particularly for small and medium sized enterprises.

FIAS (Foreign Investment Advisory Service). 1998a. *Strengthening the Collection and Dissemination of Foreign Investment Statistics in Egypt*. Cairo, Egypt.

The paper argues that Egypt has stepped up its market reforms efforts to integrate in the global economy, including a more friendly FDI regime. Accordingly, the objective of this study/project is to assist the Government of Egypt in strengthening and developing a framework for collection and dissemination of foreign investment statistics in Egypt consistent with standard international definitions. In addition, the study -- after reviewing the existing system -- provides specific recommendations for improving the definition, quality and coverage of statistics on inward foreign investment in the economy (the current system is a myriad of collection, processing and dissemination of statistical processes, distributed among a number of agencies -- Central Bank of Egypt, The General Authority for Investment, The Companies Organization, The Egyptian General Petroleum Corporation -- each applying definitions and classifications according to own criteria. Not surprisingly, the level of details in the various databases is insufficient to provide a comprehensive picture of annual inflows and operating characteristics of FDI. The study stresses the need for a system that collects and classifies the available information from various sources, consolidates and analyzes the appropriate data, and produces comprehensive estimates of FDI inflows, including statistics on operations and output of foreign firms.

FIAS (Foreign Investment Advisory Service). 1998b. *Egypt Reform Investment Administration and Strengthen Investment Servicing*. Cairo, Egypt.

This study argues that although Egypt has begun to offer foreign investors a relatively better investment climate, many policy changes have not been effective, in large part because of lack of reforms in the administrative system. In fact, the bureaucratic procedure is riddled by bottlenecks, particularly in company incorporation and registration, site development, establishment and operation licensing, and access to land for investment purposes. The study calls for a large reduction in the number of government agencies that currently shape the decision making process, as well as for an expanding role of the investment promotion units which operate at both, the national and sub-national levels. It provides recommendations related to simplifying approvals and facilitating investment procedures which include: (i) introduction of automatic company registry; (ii) consolidation of regulations and oversight of company incorporation within one government agency; (iii) elimination of unnecessary requirements and consolidation of as much as possible of those that are still required; (iv) limits to operation licenses in industries where public and health welfare are concerned; (v) market-based land reform; (vi) reduction of time required to authorize land transactions; and (vii) promotion of privately owned, developed and managed industrial estates.

Mahboub, A. 1999. Foreign direct investment in Egypt: How to encourage and maximize the benefits. L'Egypt Contemporaire. Forthcoming.

The study aims at investigating the current and potential role of FDI in Egypt, and means of attracting and benefiting from it. It shows that FDI inflows in Egypt have increased, although they are still below the country's potentials. The study points out that Egypt is characterized by a relatively stable macroeconomic and political environmental, and is blessed by a relatively large market size. Yet, Egypt still suffers from major FDI impediments compared to successful countries in both Latin America and East and Southeast Asia, such as high tariff rates and inflexible labor regulations. The study presents the sectoral distribution of FDI inflows in Egypt, which reveals that the economy has a potential comparative advantage in the industrial sector and that it just needs to eliminate price distortions. Successful case studies in Mexico, Thailand and Malaysia are highlighted.

INP (Institute of National Planning). 1996. Role of Free Zones in Developing Exports. October 1996. (Arabic). Cairo, Egypt.

This study discusses the theoretical rationale of free zones for the development of an economy. It underlines the importance of an export strategy in the context of the Egyptian economy. The study analyzes free zones all over the world with special emphasis on developing economies, pinpointing their developmental role. It focuses on those of Egypt and provides recommendations to attract more investment. It also offers a socio-economic cost-benefit evaluation of the free zones and results of a survey on performance.

ERF (Economic Research Forum for the Arab Countries, Iran, and Turkey). 1998. *Economic Trends in the MENA Region 1998*. Cairo, Egypt.

This study shows that Turkey, Egypt, Morocco, and Tunisia account for most FDI flows to MENA region (74 percent). In contrast to the upward trend in FDI flows for most developing countries, inflows to the MENA region have remained constant or fallen in percentage terms of GNP in the 1990s, particularly due to the slow pace of liberalizing FDI regimes, implementing structural reforms, and removing regulatory impediments in the region. The performance reflects the generally less friendly climate for private sector investment and perceptions abroad of high political risk in the region. The study considers that Egypt has been doing very well in the last five years, except 1995. Tunisia is doing reasonably well, given its high income per capita. The study defines 5 groups of factors that constitute what may be called the pyramid of FDI behavior: societal attractiveness (includes the society's openness and its general attitude towards foreigners and foreign-owned property); infrastructural attractiveness (includes the quality and coverage of infrastructure, property rights and their administration, and the stock of existing FDI); factors attractiveness (reflecting the availability and quality of human, capital resources and raw material); governable attractiveness or general ability of the governing elite to achieve consensus within a rule of law; and competitive attractiveness (the importance of the country's situation and capabilities in the competitive game in which MNEs are involved). These indicators help explain the failure to attract sufficient FDI flows to the region.

Gabr, A. 1997. The Investment Environment in Egypt: A Study measuring the public opinion. (Arabic)

This study is based on questionnaires and meetings with 400 local investors and 100 Arab investors to assess the investment environment. It identifies the following factors as being the most important to attract investors in Egypt: market size, exchange rate stability, and political stability. On the other hand, the study has also pointed out negative factors deterring investment in Egypt, such as: dispute settlements that take too long, high tax levels, inconsistency of laws and policies, and multiplicity of agencies responsible for investment decisions.

Latin America

Agosin, Manuel R., compilador, 1996. Inversión Extranjera Directa en América Latina: Su *Contribución al Desarrollo*. Santiago, Chile: Fondo de Cultura Económica.

By the director of School of Economics of Universidad de Chile, this volume contains an overview of foreign direct investment in Latin America and three in-depth country case

studies Argentina, Chile and Colombia. FDI has been concentrated in Argentina, Chile, Mexico, Peru and Venezuela. The principal determinants of FDI include: (1) A friendly FDI regime. Unlike past decades, Latin American countries do not seek to regulate foreign investment. To the contrary, they now compete to attract MNEs. (2) Political and macroeconomic stability. This was achieved after a long period of economic stagnation and over-indebtedness. Recovery of FDI, to a large extent, represents an upward correction of the low FDI inflows that characterized the 1980s. (3) The relatively large size of domestic markets. (4) The opportunities opened by regional trade blocs, most especially the Andean Group and Mercosur. And (5) Potential for export to developed countries. With the exception of Mexico, the perspective for the signing of free trade agreements with the United States has not been a determining factor. The author argues that FDI has helped raise gross capital formation. With respect to its contribution towards increasing international competitiveness, the author believes that, with a few notable exceptions, FDI, so far, has not been a positive factor. The bulk of Latin American countries have yet to expand and diversify exports vigorously. Exceptions are Mexico, which has benefited from economic integration with the United States and, to a lesser extent, Chile. In Argentina, the establishment of Mercosur and the outlook for a larger regional market has attracted MNEs. Finally, as regards the role of FDI in fostering technological innovations, the author points out that there is evidence that Mexico has benefited from the introduction of better production processes and managerial techniques, updating skills of the workforce, and the raising of total factor productivity that all this entails. 209 pages.

Asia

Pangestu, M. 1997. Indonesia: Trade and foreign investment linkages. In *Multinationals and East Asian integration*, eds., W. Dobson and C.S. Yue. Ottawa and Singapore: International Development Research Centre and Institute for Southeast Asian Studies.

This paper, by a leading authority on the Indonesian economy, provides a valuable discussion of Indonesia’s adoption of open foreign trade and investment policies during the 1980s and its ensuing ascendancy as a predominantly manufacturing exporter, against the backdrop of the country’s traditional reliance on petroleum exports for foreign exchange earnings revenues. The paper also contributes an analysis of how Indonesian firms that are engaged in international production are participating in the economic integration of the East and Southeast Asian region through intra-regional and intra-firm trade, based on an extensive firm-level survey. The paper emphasizes the importance of outward-oriented trade and investment policies for Indonesia’s transformation from a predominantly mineral fuels exporter to a predominantly manufacturing exporter. It also emphasizes important expectations on the part of foreign investors in Indonesia, namely, for policy transparency and nondiscriminatory treatment, and for ready and cheaper access to intermediate inputs to their production processes, both from local and foreign suppliers.